[JOINT COMMITTEE PRINT]

FEDERAL INCOME TAX TREATMENT OF PASS-THROUGH ENTITIES (INCLUDING A DESCRIPTION OF H.R. 1658, H.R. 2571, H.R. 3397, AND H.R. 4448)

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON JUNE 9 AND 10, 1986

PREPARED BY THE STAFF

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INTRODUCTION

This pamphlet[1] is prepared in connection with the hearings to be held by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on June 9 and 10, 1986. The first day of hearings is to review the present Federal income tax treatment of pass-through entities generally. The second day of hearings is to cover four bills that would affect the present Federal income tax treatment of certain pass-through entities.

The four bills scheduled for hearing on June 10, 1986, are: (1) H.R. 1658 (tax treatment of business development companies); (2) H.R. 2571 (tax treatment of real estate investment trusts); (3) H.R. 3397 (tax treatment of regulated investment companies); and (4) H.R. 4448 (tax treatment of entities owning real estate mortgages).

The first part of the pamphlet provides background information, primarily to be used in connection with the hearing on June 9, 1986, including a description of present law and an analysis of the issues raised by the treatment of pass-through entities. The second part of the pamphlet is a summary of the four bills scheduled for the hearing on June 10, 1986. The third part of the pamphlet provides a more detailed description of the bills, including present law, issues raised by the bills, explanation of provisions, and effective dates.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Federal Income Tax Treatment of Pass-Through Entities (Including a Description of H.R. 1658, H.R. 2571, H.R. 3397, and H.R. 4448* (JCS-13-86), June 9, 1986.

I. BACKGROUND ON TAX TREATMENT OF PASS-THROUGH ENTITIES

Present Law

Overview

Owners of a business or of income producing property may wish, for a variety of business or other reasons, to use a separate entity to conduct the business or hold the property. The tax consequences of using a separate entity depend on the type of entity that is used.

Present law sets forth criteria applicable in distinguishing among types of entities that receive pass-through tax treatment, and in distinguishing such pass-through entities from C corporations, which are subject to tax at the entity level. In general, applicable Treasury regulations provide factors for distinguishing among partnerships, corporations and trusts. In addition, special rules apply to certain types of passthrough entities including S corporations, regulated investment companies, real estate investment trusts, cooperatives, and housing cooperatives.

Description of various types of entities

Corporations

A corporation that does not qualify for special conduit treatment ("C corporation") generally is taxed as an entity separate from its shareholders. Thus, the corporation's income generally is taxed when earned at the corporate level, and is taxed again when distributed as dividends [2] to individual shareholders.

Corporate income that is not distributed to shareholders is subject to current tax at the corporate level only. To the extent that income retained at the corporate level is reflected in an increased share value, the shareholder may be taxed at favorable capital gains rates upon sale or exchange (including certain redemptions) of the stock or upon liquidation of the corporation.[3]

Corporate deductions and credits reduce only corporate income and are not passed through to individual shareholders.

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[2] Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock and accordingly may be taxed to the shareholder at capital gains rates.

[3] If an individual shareholder retains stock until death, the appreciation can pass to the heirs free of income tax (sec. 1014). In addition, in the case of certain corporate distributions in liquidation or in certain redemptions, unrealized appreciation in corporate assets can escape corporate tax entirely (apart from the recapture of specified items, such as certain prior depreciation deductions). In such cases, only a capital gains tax at the shareholder level may be imposed on the appreciation when the assets are distributed to the shareholders, or sold to a third party and the proceeds distributed.

Partnerships

A partnership is a conduit—i.e., it receives pass-through treatment—for purposes of income tax liability and payments. Each partner takes into income his "distributive share" of the partnership's taxable income and the separately allocable items of income, deduction, and credit (sec. 702(a)). The liability for Federal income tax payment is that of the partner, and not of the partnership (sec. 701).

Conduit treatment for the partnership means that income is taxed at only one level: the partner's level. Also, this means that the partner is taxed on the partnership profits even though none of those profits may actually be distributed to the partner.

Conduit treatment for partnerships also means that any partnership losses, deductions, and credits pass through to the partner and can be used to offset other income, thereby reducing the income tax liability of the partner. The amount of losses that a partner may deduct under these provisions for a particular year may not exceed the amount of the adjusted basis of his partnership interest (sec. 704(d)), which, at the inception of the partnership, equals the sum of his capital contribution to the partnership plus his share, if any, of partnership liabilities.

Partnerships have been utilized to provide partners a significant amount of flexibility to vary their respective shares of partnership income. Unlike some other types of pass-through entities (discussed below), partnerships permit a significant amount of flexibility in allocating specific tax consequences to particular partners; for example, depreciation deductions can be allocated disproportionally to a partner; or taxable income (but not current cash flow) can be allocated disproportionately to another partner. The Code permits such allocations only to the extent they have "substantial economic effect". Within this limitation, however, partners in many instances effectively can utilize such allocations to transfer tax attributes.

Trusts

A trust can also function as a conduit. Some trusts ("grantor trusts") are taxed as if the property were still retained by the grantor. Generally, however, a trust is taxed as a separate entity. It receives a deduction for distributions to beneficiaries, however, and beneficiaries generally include the distributed amounts in income. A trust generally may not engage in active business activities without risking reclassification as a corporation.

Other statutory entities

Certain entities that are organized as corporations or as trusts and that meet specified requirements are taxed under special statutory provisions. In different ways, these provisions basically permit tax to be imposed at a single level, rather than at both the entity level and the owner level. In general, relief from the corporate income tax is given to income earned by corporations electing under subchapter S ("S Corporations"), regulated investment companies ("RICs"), real estate investment trusts ("REITs"), and certain cooperatives.

Classification rules

Taxpayers have a significant amount of flexibility under present law to determine the tax results of their arrangements by selecting the form of entity in which a business will be conducted or property held.

The Code defines the term "corporation" to include "associations," whether or not organized in corporate form (sec. 7701(a)(3)). Thus, an entity organized as a pass-through entity, such as a partnership or a trust, may be reclassified for tax purposes if it more nearly resembles a taxable C corporation. Whether it more nearly resembles a corporation depends on a variety of factors, including the relationship of the owners to the entity and the types of activity the entity conducts.

Morrissey case

The Supreme Court articulated standards applicable in determining whether an entity should be taxed as a corporation in the case of *Morrissey* v. *Commissioner*, 296 U.S. 344 (1935). That case involved an organization established as a trust under state law and reclassified by the IRS as an "association," taxable as a corporation. The organization was empowered to operate a golf course and to sell, lease or operate other lands. It platted and sold lots, and constructed and operated a golf course and golf club. Beneficial interests were evidenced by transferable share certificates, evidencing both common and preferred interests, held by hundreds of persons. The Supreme Court concluded that the organization was properly taxed as a corporation, given the entity's centralized control and continuity of life, the limited liability of shareholders, and the fact that the entity essentially was conducting a business enterprise. The court reasoned that the entity resembled a corporation. Thus, the *Morrissey* case is said to have set forth the "resemblance" test referred to in the Treasury regulations regarding entity classification.

Treasury regulations

Treasury regulations under section 7701 of the Code provide that whether a business entity is taxed as a corporation depends on which form of enterprise the entity "more nearly" resembles (Treas. Reg. sec. 301.7701-2(a)). The regulations list six characteristics which distinguish an association taxable as a corporation from other entities. These are: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests.

In general, the Treasury regulations provide that each of the factors is to be accorded the same weight. In order to be treated as a corporation for Federal income tax purposes, an unincorporated entity must have more corporate characteristics than noncorporate characteristics.

Classification as partnership or corporation

In general

In distinguishing partnerships from corporations, the Treasury Regulations provide that the factors of the presence of associates and an objective to carry on business and divide the gains therefrom are common to both partnerships and corporations.[4] Whether an entity is to be classified as a partnership or a corporation depends, under the Treasury regulations, on whether the entity has more than two of the remaining four principal "corporate" characteristics of a business entity. The effect of the Treasury Regulations generally is to classify an entity as a partnership if it lacks any two of these four critical corporate characteristics without further inquiry as to how strong or weak a particular characteristic is or how the evaluation of the factors might affect overall resemblance (Treas. Reg. secs. 301.7701-2 and -3).[5]

These regulations, known as the "Kintner" regulations, were basically adopted in 1960 in response to a decision of the Ninth Circuit in *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954). In that case, the Ninth Circuit held that an association, formed by a physician to establish a pension plan for his benefit as a shareholder/employee of a corporation, was properly treated as a corporation, not a partnership. The taxpayer in that case obtained the benefit of more favorable pension plan rules applicable, at that time, to corporate employees but not to partners. Responding to this decision, the Treasury Department revised the partnership classification regulations in 1960 so as to make it more likely that an association would be classified as a partnership and not a corporation.[6]

Specific factors

Under the Treasury Regulations, an organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution of the organization. In the case of a limited partnership, if the retirement, death, or insanity or a general partner causes a dissolution unless the remaining general partners (or all the remaining members) agree to continue the partnership, continuity of life does not exist. The regulations provide that a general or limited partnership subject to a statute corresponding to the Uniform Partnership Act or

[4] The presence or absence of these two factors may, however, serve to distinguish a corporation or partnership, on the one hand, from another type of entity such as a trust, on the other hand. *See*, discussion under "Classification as a Trust or Corporation," *infra*.

[5] *See*, *Larson v. Commissioner*, 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1; Rev. Rul. 79-106, 1979-1 C.B. 448.

[6] The Tax Equity and Fiscal Responsibility Act of 1982 changed the favorable pension plan treatment of shareholders who are also corporate employees (as compared, for example, to partners). Thus, this reason for changing the partnership classification regulations as they were changed in 1960 no longer exists. The Tax Court in *Larson* upheld the taxpayer's view that certain entities were properly treated as partnerships rather than corporations. The court stated: ". . . if the overall corporate resemblance test . . . permits us to weigh each factor according to the degree of corporate similarity it provides, we would be inclined to find that these entities were taxable as corporations. Each possessed a degree of centralized management indistinguishable from that of a pure corporation; the other major factors lie somewhere on the continuum between corporate and partnership resemblance. Were not the regulations' thumb upon the scales, it appears to us that the practical continuity and limited liability of both entities would decisively tip the balance in respondent's [the Commissioner's] favor. However, we can find no warrant for such refined balancing in the regulations or in cases which have considered them." 66 T.C. at 185 (1976).

the Uniform Limited Partnership Act generally lacks continuity of life. Under these rules, continuity of life generally does not exist even if the remaining partners have agreed to continue the partnership.[7]

An organization generally has centralized management, under the regulations, if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. A general partnership subject to a statute corresponding to the Uniform Partnership Act generally cannot achieve centralization of management because of the mutual agency relationship between the partners. A limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act generally does not have centralized management unless substantially all the interests in the partnership are owned by the limited partners. However, if all or a specified group of the limited partners may remove a general partner (even with a substantially restricted right of removal), the test for whether there is centralized management is to be based on all the facts and circumstances.

Under the Treasury Regulations, an organization has limited liability if, under local law, there is no member who is personally liable for the debts of, or claims against, the organization. In the case of an organization subject to a statute corresponding to the Uniform Partnership Act (or the Uniform Limited Partnership Act), personal liability generally exists with respect to each general partner. In the case of a limited partnership, however, personal liability does not exist with respect to a general partner when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization, and is merely a "dummy" acting as the agent of the limited partners. The Internal Revenue Service has taken the ruling position that a corporate general partner in a limited partnership does not have substantial assets unless, in the case of a partnership with total contributions of less than $2,500,000, its net worth is greater than or equal to the lesser of $250,000 or 15 percent of the total contributions to the partnership, or in the case of a partnership with total contributions of $2,500,000 or more, its net worth is at least 10 percent of the total contributions to the partnership (Rev. Proc. 72-13, 1972-1 C.B. 735). However, if it meets these tests, it will be considered to have substantial assets, and the entity thus will be considered not to have limited liability, for advance ruling purposes. Taxpayers have successfully contended that there is no limited liability under the regulations if the corporate general partner is not a "dummy" acting as the agent of the limited partners. (*See Larson* v. *Commissioner* (*supra,* note 5).)

An organization has free transferability of interests if members owning substantially all of the interests have the power, without the consent of other members, to substitute another person as a member and to confer upon his substitute all the attributes of his

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[7] *See*, Rev. Proc. 86-3, 1986-1 C.B. 26, describing certain situations in which the Internal Revenue Service will not issue an advance ruling regarding the classification of an entity as a partnership; including issues relating to continuity of life.

interest. Free transferability of interests does not exist, under the regulations, if a transfer of a member's interest results in the dissolution of the old organization and the formation of a new organization.[8]

Classification as trust or corporation

In general.—The Treasury Regulations also provide that, in general, the term "trust" refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts (Treas. Reg. sec. 301-7701-4). The regulations further provide that, in general, an arrangement will be treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Since the four characteristics discussed above that distinguish partnerships from corporations generally are common to trusts and corporations, the Treasury Regulations use the other factors—namely the presence of associates and an objective to carry on business and divide the gains therefrom—in distinguishing a trust from a corporation for Federal income tax purposes (see Treas. Reg. sec. 301.7701-2(a)(2)).

Thus, an entity will not be treated as a trust if the trust is used for carrying on a profit-making business that ordinarily would be carried on through a business organization such as a corporation or partnership, such is often the case in the case of certain types of organizations which are known as business or commercial trusts (e.g., a Massachussetts business trust) (Treas. Reg. sec. 301.7701-4(b)).

Management trusts.—The Treasury Regulations provide that an investment trust (sometimes also called a "management trust") is generally treated as an association taxable as a corporation where there is power under the trust agreement to vary the investment of the certificate holders. Nontheless, where there is not power under the trust agreement to vary the investment of the certificate hold-

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[8] Particularly as applied to limited partnerships, the characteristics set forth in the regulations have been criticized as unrealistic. Critics claim that a revision of the classification test that more realistically analyzes these factors and others would result in many entities now classified as partnerships being treated as corporations. (*See* Sexton and Osteen, *Classification as a Partnership or an Association Taxable as a Corporation,* 24 Tulane Tax Institute 95 (1975)) The Tax Court, in the case of *Larson v. Commisssioner* (*supra,* note 5) applying the regulations, suggested that additional factors might be relevant in determining whether a limited partnership should be reclassified as a corporation. In 1977, the Treasury Department issued, and immediately withdrew, proposed regulations intended to make the test for reclassification more realistic, particularly as applied to limited partnerships. The proposed rules (42 Fed. Reg. 1038 (Jan. 5, 1977)) would have tightened the test with respect to the continuity of life and centralized management factors, and generally would have required the examination of additional factors if an entity had two of the four corporate characteristics. The proposed regulations were intended as a response to criticism that the existing regulations deviated from the "resemblance test" in the *Morrissey* case, on which they were based. After the 1977 proposed regulations were withdrawn, the Internal Revenue Service subsequently indicated, in Rev. Rul. 79-106, 1979-1 C.B. 448, that it would follow the *Larson* application of the existing regulations, without examining additional factors. Thus, the issue under present law—whether the test for partnership status in the existing regulations is inappropriate, especially as applied to limited partnerships—remains unresolved. resolved.

ers (as occurs in the case of so-called a "fixed investment trust" or "unit investment trust"), the entity will not be treated as a corporation.

Liquidating trusts.—The Treasury Regulations provide that organizations which are commonly known as "liquidating trusts" (i.e., a trust organized for the primary purpose of liquidating and distributing the assets transferred to it) and similar organizations are generally treated as trusts (Treas. Reg. sec. 301.7701-4(d)). A liquidating trust is treated as a trust because it is formed with the objective of liquidating particular assets and not as a organization having as its purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships. However, under the Treasury Regulations, if the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation is lost or abandoned, the organization may no longer be treated as a trust.

Grantor trusts

Finally, present law provides that a grantor trust is not treated as a trust for Federal income tax purposes, but rather the incidence of taxation falls upon the grantor, because the grantor is treated as the owner of the trust (sec. 671). In general, a grantor of a trust is treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income, if, as of the inception of that portion of the trust, the interest in the trust will or may reasonably be expected to revert to the grantor within 10 years (sec. 673(a)). The grantor of a trust generally is also treated as the owner if he (or a nonadverse party) has certain powers to control beneficial enjoyment of the corpus or income, or has certain administrative powers over the trust, or has the power to revoke the trust in some circumstances, or may distribute or accumulate the income for the grantor or the grantor's spouse or use the income to pay premiums on insurance on the life of the grantor or the grantor's spouse (secs. 674-677). Thus, in general, if the grantor retains sufficient powers or obtains sufficient current benefits from the trust, he is treated as the owner.

Classification of entities with multiple classes of ownership

In May 1984, the Treasury Department issued proposed regulations addressing the treatment of trusts that have more than one class of ownership interest. Final regulations were issued in March 1985 (Treas. Reg. sec. 301.7701-4(c)(1)). Under these regulations, a trust is treated as having one class of ownership if all of the beneficiaries of the trust have undivided interests in all of the trust property. More than one class of ownership may exist where, for example, some beneficiaries are entitled to received more than their pro rata share of trust distributions in early years and other beneficiaries are entitled to more than their pro rata share in later years.

Under the regulations, an arrangement having more than one class of ownership interest generally is not treated as a trust, but is treated as a corporation. Thus, if a trust held a portfolio of mortgages, and interest in the trust were to receive all principal collected by the trust and a specified rate of interest thereon, until the

trust had collected a specified amount of principal on the mortgages, and another class of beneficiaries were to receive all remaining amounts collected by the trust, then such trust would be treated as an association taxable as a corporation under the regulations. The regulations provide a limited exception for certain trusts with multiple classes, where the existence of multiple classes is incidental to the purpose of facilitating direct investment in the assets of the trust. These regulations apply to interests issued after April 27, 1984.

Special rules for the taxation of certain entities

S corporations

Subchapter S of the Code, which provides for the definition and tax treatment of S corporations and their shareholders, was enacted in 1958 to minimize the effect of Federal income tax considerations on the choice of form of business organization. The provisions of subchapter S permit the incorporation and operation of certain businesses without the incidence of income taxation at both the corporate and shareholder levels. (See S. Rept. No. 1983, 85th Cong., 2d Sess., 87 (1958).) Substantial simplifying changes to the provisions were enacted in the Subchapter S Revision Act of 1982. (See S. Rept. No. 97-640, 97th Cong., 2d Sess., 6 (1982).) The Act continued the ability of eligible corporations to elect a single level shareholder tax on earnings. It removed certain limitations on S corporation activities (including prior-law prohibitions against excessive passive income). The Act also generally increased the extent to which the S corporation is treated as a pure conduit under rules similar to partnership rules, rather than as a modified corporate entity.

Under present law, in order to be eligible to elect S corporation status, a corporation may not have more than 35 shareholders and may not have more than one class of stock. Only individuals (other than nonresident aliens), estates and certain trusts are permitted as shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than half the stock (sec. 1362). Although there are limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the size of such a corporation.

There is no requirement that an S corporation be engaged in an active business. However, excess passive investment income can cause the automatic termination of S corporation status in some circumstances if an S corporation was previously a C corporation and still has C corporation earnings and profits. In such a case, if the S corporation has passive income amounting to more than 25 percent of its gross receipts for 3 consecutive years, the corporation loses its S corporation status. This rule is intended to prevent a regular C corporation from electing S status and converting, essentially, into a holding company, rather than liquidating and incurring tax at the shareholder level on liquidation proceeds from the period of operation as a C corporation.

S corporations generally are treated for Federal income tax purposes as pass-through entities, not subject to tax at the corporate

level (secs. 1363 and 1366). Items of income (including tax-exempt income), loss, deduction and credit of the corporation are taken into account in computing the tax of the shareholders. A shareholder's deduction for corporate losses is limited to the amount of the shareholder's adjusted basis in his stock and in the indebtedness of the corporation to such shareholder. To the extent a loss is not allowed due to this limitation, it generally is carried forward to the next year. The shareholder's basis in his stock and debt is reduced by his share of losses allowed as a deduction and, in the case of stock, by distributions, and the shareholder's basis in his stock is increased by his share of the corporation's income (sec. 1367).

There are two principal exceptions to the general pass through treatment of S corporations. Both are applicable only if the corporation was previously a C corporation and are generally intended to prevent avoidance of otherwise applicable C corporation tax consequences. First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if (for less than 3 consecutive years [9]) the corporation has subchapter C earnings and profits, and has gross receipts more than 25 percent of which are passive investment income for the year (sec. 1375).

Second, for the first 3 years after a corporation which was previously a regular C corporation elects to be an S corporation, capital gains of the corporation are subject to tax at the corporate level if they exceed a certain amount (sec. 1374).[10]

In general, a shareholder is not subject to tax on distributions unless they exceed the shareholder's basis in his stock of the corporation or, in general, unless the corporation was formerly a C corporation and has remaining earnings and profits (sec. 1368). To the extent of such earnings and profits, corporate distributions are treated like dividends of C corporations and generally are subject to tax as ordinary income in the hands of the shareholders.

Real estate investment trusts

Under the provisions of the Code applicable to REITs (secs. 856 *et seq.*), REITs generally are treated as conduits for Federal income tax purposes to the extent of the amount of its earnings that are distributed currently to shareholders. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed on a current basis. Thus, income that is currently distributed to shareholders is not taxed at the REIT level; income that is not currently distributed to shareholders is taxed at the REIT level, as in the case of ordinary corporations.

In general, an entity may qualify as a REIT if it is a trust or corporation with at least 100 different freely transferable interests, and would be taxable as an ordinary domestic corporation but for

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[9] If the S corporation continues to have C corporation earnings and profits and has gross receipts more than 25 percent of which are passive investment income in each year for 3 consecutive years, the S corporation election is automatically terminated.

[10] If the net capital gain of the corporation exceeds $25,000, and exceeds 50 percent of its taxable income (with certain adjustments) for the year, and the corporation's taxable income (as adjusted) exceeds $25,000, then corporate level tax is imposed on the net capital gains of the corporation in excess of $25,000 (or, if the tax is lower, the taxable income (as adjusted) of the corporation calculated as if it had not elected subchapter S status).

its meeting certain specified requirements. These requirements relate to the entity's assets being comprised substantially of real estate assets and the entity's income being, in substantial part, realized from certain real estate and real estate related sources.

The ability of a REIT to engage in regular business activities is limited by several different requirements. First, is the requirement that any services provided in connection with the rental of real property must be rendered through an independent contractor in order for the rent to qualify toward the REIT's income requirement. Second, is the imposition of a 100 percent tax on gains from the sale of property held for sale to customers in the ordinary course of trade or business (other than foreclosure property). Third, is the requirement that income from the sale or other disposition of stock or securities held for less than 1 year, or real property held less than 4 years, must account for less than 30 percent of the REIT's income. In addition, income is not treated as being derived from qualified sources if its permits the corporation directly or indirectly to engage in an active business.

If a corporation meets these requirements and elects to be treated as a REIT, it generally is subject to the regular corporate tax, but receives a deduction for dividends paid provided that the amount of its dividends paid is not less than an amount generally equal to 95 percent of its ordinary income. These dividends must be paid within a short period following the close of the REIT's taxable year and generally are includible as ordinary income to the shareholders.[11]

A REIT that realizes capital gain income may be subject to tax at the corporate level at capital gains rates. If, however, the REIT pays dividends out of such capital gains, the dividends are deductible by the REIT in computing its tax on capital gains and are taxable as capital gains to the recipient shareholders.

Regulated investment companies

Conduit treatment similar to that granted to REITs also is provided to regulated investment companies ("RICs"). In general, a RIC is an electing domestic corporation that either meets, or is excepted from, certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), that derives at least 90 percent of its ordinary income from specified sources commonly considered passive investment income, that has a portfolio of investments that meet certain diversification requirements, that distributes at least 90 percent of its income to its shareholders annually, and that also meets certain other requirements.

The ability of a RIC to engage in an active business is limited by several of these requirements. First, the requirement of registration under the Investment Company Act of 1940 limits the activities that the RIC may engage in. Second, the requirement that most of the RIC's assets must be and most of its income must be derived from stock or securities assures that the RIC cannot engage in any business activities unrelated to investing in stock or securi-

[11] A deficiency dividend procedure was added to the REIT provisions as part of the Tax Reform Act of 1976 so that a REIT, acting in good faith but failing to satisfy the distribution requirement, could avoid disqualification.

ties. This assurance is bolstered by certain diversification requirements, which generally prevent RICs from exercising managerial authority as a result of substantial stock ownership. In addition, the ability of a RIC to actively engage in the business of trading securities is limited by the requirement that less than 30 percent of the gross income of the RIC may be derived from gain on the sale or other disposition of stock or securities held for less than three months.

A RIC, like a REIT, generally is subject to the regular corporate tax, but receives a deduction for dividends paid to its shareholders. Rules similar to those applicable for REITs apply to distributions of capital gain dividends, and distributions of deficiency dividends.

Cooperatives

Certain corporations are eligible to be treated as cooperatives and taxed under the special rules of subchapter T of the Code. In general, the subchapter T rules apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, most tax-exempt organizations, and certain utilities).

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one important exception—the cooperative may compute its taxable income without regard to amounts paid to its patrons as patronage dividends. In general, patronage dividends are amounts that are rebated to its patrons pursuant to a preexisting obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative. This rebate may be in a number of different forms.

In general, a cooperative is permitted to compute its taxable income without regard to patronage dividends only to the extent of net income derived from transactions with its members. Thus, cooperatives generally are subject to corporate tax on profits derived from transactions with nonmembers.[12]

Members of the cooperatives who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative markets a product for one of its members, patronage dividends attributable to the marketing are treated like additional proceeds from the sale of the product and are includible in the recipient's income. Where the cooperative purchases equipment for its members, patronage dividends attributable to equipment purchases are treated as a reduction in the recipient's basis in the purchased equipment (provided the recipient still owns the equipment).

Cooperative housing corporations

Under present law, a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid or accrued by the cooperative to the extent that such amounts represent the taxpayer's proportionate share of (1) real estate taxes allowable as a de-

[12] In addition, if an entity qualifies as a tax-exempt farmers' cooperative under section 521(b) of the Code, it generally may deduct patronage dividends to the full extent of its net income and also may deduct, to a limited extent, dividends on its common stock.

duction to the cooperative which are paid or incurred by the cooperative with respect to the cooperative's land or buildings, and (2) interest allowable as a deduction to the cooperative, that is paid or incurred by the cooperative with respect to indebtedness contracted in the acquisition of the cooperative's land or in the acquisition, construction, rehabilitation, etc. of the the cooperative's buildings.

In general, a cooperative housing corporation is a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled solely by reason of ownership of stock, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution not out of earnings and profits of the cooperative, except on complete or partial liquidation of the cooperative, and (4) 80 percent of more of the gross income for the taxable year of which is derived from tenant stockholders. A tenant-stockholder generally is an individual owning fully paid up stock in the cooperative corporation, the purchase price of which bears a reasonable relationship to the value of the cooperative's equity in its land and buildings that is attributable to the dwelling unit that the individual is entitled to occupy.

Analysis

In general

When a legal entity (e.g., a corporation, partnership, or trust) holds property or otherwise engages in an activity that gives rise to tax consequences (i.e, income, deductions, or credits), a question arises as to the appropriate taxpayer or taxpayers to which such tax consequences should be attributed. It generally is agreed that attribution to some taxpayer must be made in the year in which such consequences arise in order to avoid creating serious distortions and disparities within the income tax system. If, for example, the income of an entity were treated as currently taxable neither to the entity as a separate taxpayer, nor to any owners of the entity, then taxpayers who earned income through the use of entities would benefit from a deferral of tax liability that is not available when one earns income without using an entity.[13]

The critical issue, therefore, is whether income tax should be imposed on, or other tax consequences recognized by, the entity as well as the owners of the entity, or simply the owners in proportion to their ownership interests. A number of different factors may be viewed as relevant to this determination.

Grounds for treating an entity as a separate taxable unit

The issue of whether or not an entity should be treated as a separate taxable unit may turn in large part on the relationship between the entity and its owners. In particular, to the extent that an entity is viewed as acting separately from its owners, rather than merely as their agent or alter ego, an argument can be made that it should be treated as a separate taxable unit.

[13] This result would be little different substantively from treating entities, in effect, as "bank accounts" with respect to which earnings on deposits were not taxable until withdrawal. Such a result arguably would be appropriate under a consumption tax, but is inconsistent with the notion of an income tax, which generally is designed (except with regard to preferences, which generally are focused to meet specific policy goals) to tax income when earned, not when spent.

There are several reasons why it may be appropriate to impose separate taxable status on an entity that is acting separately from its owners, rather than merely as their agent or alter ego. Separate action by the entity suggests that it, rather than the owners, is the party that actually is earning the income in a realistic and substantial economic sense. To the extent of such separate action, owners may not have full control either over the process of earning the income, or over the use and disposition of amounts earned that the entity retains.

Several other considerations also are relevant to the determination of whether an entity should be treated as a separate taxable unit. These considerations include whether the liability of owners with respect to debts incurred by the entity is limited, certain tax shelter and administrative issues, and concern for neutrality of tax treatment as between entities having similar characteristics.

Certain factors identified by applicable case law and regulations

Certain factors identified as relevant by applicable case law or regulations have a direct bearing on whether an entity is acting separately from its owners, or as their agent or alter ego. For example, each of the four factors relied upon by Treasury regulations to determine whether an entity is taxed as a corporation or as a partnership is relevant to this issue.[14]

The existence of either continuity of life or free transferability of interests suggest that an entity has legal significance substantially separate from the interest of a particular owner. For example, when an entity has these two characteristics, amounts earned while one is an owner may never be distributed to such owner, and amounts distributed to an owner may not have been earned during his period of ownership. Thus, if these two characteristics are present, it can be argued that taxing the entity is appropriate. More generally, such continuity and transferability suggest that the entity is not wholly dependent for its existence on the continuing involvement of current owners, and may continue to exist even if any of such owners cease to possess ownership interests.

The existence of centralization of management suggests that owners of an entity may not, at least by reason of their ownership interests, guide the activities of the entity on a regular and continuous basis. The presence of centralized management suggests at least some separation between the activities of the entity and those of owners, even though the management may be viewed, in some respects, as the agent of owners. In particular, it can be argued that an owner who is not involved in managing the entity is not properly viewed, in a realistic and substantial economic sense, as the party responsible for earning the income of the entity.

For several reasons, the fact that owners have only limited liability with respect to an entity suggests that the entity should be treated as a separate taxpayer. To begin with, limited liability establishes a potentially substantial economic distinction between owners and the entity itself. Limited liability may lessen the

[14] *See* Treas. Reg. secs. 301.7701-2 and -3, *supra*.

[15] Footnote deleted.

degree to which the economic resources of the owners themselves, rather than solely those of the entity, are critical to the conduct of the business. In addition, when the liability of owners is limited, the owners may never have to bear losses incurred by the entity in excess of the entity's capital resources. Accordingly, in such a circumstance, it may be inappropriate to view losses of the entity as realized by owners.

Administrative advantages of imposing taxation at the entity level

At least in certain circumstances, imposing taxation at the entity level also may permit the avoidance of substantial audit and administrative difficulties. When an entity is treated as a separate taxpayer, only a single tax return generally need be considered in determining the tax consequences of the entity's activities. By contrast, when taxation is levied at the owner rather than the entity level, any adjustment in the income or loss derived from the entity's activities necessitates a corresponding adjustment for each owner. This may require that the statute of limitations for a large number of returns be held open, and may necessitate multiple collection actions. Where the adjustment occurs years after the fact, transfers of ownership interests or changes in the circumstances of individual owners may impede collection of additional taxes that are due.

Administrative complexity also may result for a pass-through entity and its owners when interests are transferred for a price reflecting unrealized appreciation or depreciation in the entity's assets. In such a case, complex adjustments may be necessary, for example, to conform the entity's "inside" asset bases with the new interest-holder's "outside" basis in his or her interest in the entity.

Tax shelter issues

The treatment of an entity as a separate taxpayer also may be relevant to certain tax shelter issues. In general, a tax shelter is an investment in which a significant portion of the investor's return is derived from the realization of tax savings with respect to other income.[16] Accordingly, the extent to which a tax shelter results in tax avoidance by investors may depend upon imposing taxation at the owner level, so that deductions and credits from the tax shelter entity can be used to offset other sources of income.[17] Thus, to the extent that certain types of tax shelter arrangements are viewed as abusive or undesirable, one way to limit their effect in reducing taxation of other income may be to treat entities that generate tax shelter benefits as separate taxpayers.

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[16] In addition, a tax shelter may involve the receipt of tax-favored (or, potentially, tax-exempt) income from the investment itself. *See* Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* (JCS-34-85), August 7, 1985, at p. 2.

[17] Even to the extent that entities are treated as separate taxpayers, individuals may be able to engage in tax sheltering by investing directly in tax shelter activities, rather than through an entity. In many cases, however, individuals may have business reasons for conducting such activities in entity form (e.g., to benefit from limited liability, or to facilitate transferability of interests).

Neutrality of the tax system as between similar forms of business organization

A further reason for treating entities as separate taxpayers relates to the goal of advancing the neutrality of the tax system in its treatment of substantially similar forms of business enterprise. Such treatment may be viewed as appropriate both as a matter of fairness, and to allow taxpayers to choose the form in which they prefer to conduct business without being unduly swayed by tax considerations.

This rationale does not suggest that it is necessary to reach the same answer regarding separate taxability in the case of *all* entities (i.e., treat either all or none as separate taxpayers). For example, as between a large publicly traded C corporation on the one hand, and a small general partnership on the other, any differences in tax treatment are relatively unlikely to be determinative in light of all the nontax differences that may influence the choice of legal form.

In the case of entities that have greater similarity, however, the concern that disparate tax treatment will create competitive inequalities, and unduly influence taxpayers' choice of legal form, is more significant. For example, it can be argued that limited partnerships (especially large limited partnerships) should be treated as separate taxable entities in light of the fact that corporations, which may share with such partnerships the attributes of limited liability and centralized management, generally are so treated.

As discussed above, present law regarding classification of entities as partnerships (including limited partnerships), as opposed to corporations, has been criticized as unrealistic. Several proposals have been made for changing present law regarding classification of limited partnerships in particular.

The 1984 ALI Subchapter K Project [18] proposes that any publicly traded limited partnership be subject to tax as a corporation. Similarly, a 1983 Senate Finance Committee Staff Report [19], concerning recommendations for taxation of corporations, also included a recommendation that publicly traded limited partnerships be taxed as corporations.[20] These proposals reflect the fact that publicly traded limited partnerships arguably have free transferability of interests (since interests are often tradeable on a recognized securities exchange), limited liability for limited partners (as do all limited partnerships), centralized management (because, on an empirical basis, management must be centralized where the owners are so numerous), and continuity of life (because, despite the present law criteria on this issue, the ability to continue the partnership by vote of the members following a change in the general partner gives rise to de facto continuity, just as shareholders of corporations can re-elect board members or cause management changes).

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[18] American Law Institute, *Federal Income Tax Project—Subchapter K* (1984), at 392.

[19] Senate Committee on Finance, *Preliminary Report on the Reform of Subchapter C* (October 1983).

[20] The final report prepared by the Senate Finance Committee Staff contains no such recommendation because of the fact that at the time the final report was published, the 1984 Treasury report had recently published its broader 35-limited-partner proposal, and the Staff determined that it would not approach the issue in a piecemeal manner. Senate Committee on Finance, *The Subchapter C Revision Act of 1985: A Final Report Prepared by the Staff* (May 1985) at 72.

The 1984 Treasury report [21] proposed to tax limited partnerships with more 35 limited partners as corporations. A look-through rule would have been applied under the proposal to the owners of entities, such as corporations, holding limited partnership interests, in determining whether the 35-limited-partner threshold had been reached. This proposal was not included in the subsequent Administration proposal [22]. The proposal has been criticized as easily circumvented, because a small group of very wealthy individuals, for example, could still invest in a limited partnership with less that 35 limited partners and the partnership could still pass through tax attributes to them. Alternatively, multiple partnerships might be established to keep the investors in each one below 35.[23] The proposal would, however, provide parity in the availability of pass-through treatment to S corporations and limited partnerships, both of which (if the proposal were adopted) generally would be permitted a maximum of 35 owners and would provide limited liability for owners. Such parity, it could be argued, serves the goal of tax neutrality in business choices, such as the choice of form of business entity. On the other hand, it may be argued that the similarities which would be achieved by this rule are not essential to tax neutrality but merely to the appearance of neutrality.

Grounds for not treating an entity as a separate taxable unit

In the absence of the factors noted above, it may be viewed as inappropriate to treat an entity as a separate taxable unit. For example, to the extent that the entity is merely an agent or alter ego of the owner, it may be argued that the owner truly earns any income nominally earned by the entity, and that the owner, controls both the process of earning it and the income itself. Similarly, when an entity has relatively few owners, the audit and administrative difficulties of imposing taxation on the owner level are relatively manageable.

There also are certain additional considerations that may be viewed as supporting the conclusion that entities should not be treated as separate taxpayers. These considerations include the issue of whether an entity should be recognized as a separate taxpayer when it does not conduct a trade or business, and the question of whether income should be taxed both at the entity level when earned and at the owner level when distributed.

Conduct of an active trade or business

The fact that an entity is conducting an active trade or business may be viewed as relevant to whether it should be treated as a separate taxpayer. While the presence of a trade or business is not determinative (since both corporations and partnerships commonly are engaged in business), the absence of a trade or business may suggest that the entity should not be treated as separate.

[21] Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth* (November 1984).

[22] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985).

[23] Keyser, "Publicly Traded Limited Partnerships: The Treasury fights the Wrong War," *Tax Notes*, April 29, 1985.

For example, no separate entity level tax is imposed on RICs and REITs, which generally are passive recipients of income that conduct only limited business activities. As long as such entities are not permitted to engage in an active trade or business, conduit treatment accorded to such entities cannot result in such entities having a competitive advantage over other entities which do engage in active trades or businesses.[24] In addition, no separate entity level tax is imposed on liquidating trusts and fixed investment trusts. In the case of either type of trust, the entity is treated as not being engaged in any trade or business, since the purpose of either is only to receive income from its properties, without conducting or continuing any business. Questions may be raised, however, whether it is appropriate to consider the extent of the activities of either a fixed investment trust or a liquidating trust in deciding whether the imposition of an entity level tax is appropriate. Some may suggest that it is appropriate not to impose the entity level tax on such trusts only if no substantial activities are conducted,[25] but that an entity level tax should be imposed if the trust does undertake substantial business related activities over a prolonged length of time.[26]

In general, one of the principal reasons for recognizing entities as having separate legal existence (i.e., for nontax purposes) is to assist taxpayers in conducting business in the form most convenient to themselves. For example, the selection of corporate or partnership form permits taxpayers to make use of established legal standards regarding such issues as management rights, distribution of profits, liability, and treatment of an individual who wishes to terminate his ownership interest.

In the absence of a trade or business that is being conducted by the entity, a concern arises in the tax context that the entity may be used for tax avoidance purposes. For example, individuals may seek in some circumstances to avoid or defer tax liability with respect to portfolio income (e.g., interest and dividends) by transferring the assets that produce such income to an entity. One way in which the tax law seeks to limit this avoidance technique is to treat certain entities that are not involved in the conduct of a trade or business as grantor trusts, the income of which is taxed to owners rather than to the entity.[27]

Integrating taxation at the entity and the owner levels

An additional ground that may be relied upon for arguing against taxation at the entity level relates to the fact that, if the entity is treated as a separate taxpayer, its income may, in effect, be taxed a second time upon distribution to shareholders. To the

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[24] *See* Sections. 511-514, which imposes a tax on income of an otherwise exempt organization derived from a trade or business that is not related to its exempt purpose. The stated purpose of imposing a tax on such income is to prevent tax exempt entities from having a competitive advantage over taxable entities.

[25] For example if the trust's activities are limited to receiving interest and dividend income.

[26] For example, if the trust conducts extraction, sales and delivery activities over a lengthy period in connection with the exploitation of natural resource assets.

[27] Even when the entity that is deriving nonbusiness income clearly constitutes a separately taxable corporation for tax purposes, certain provisions in the Internal Revenue Code are designed to address undue avoidance or deferral of taxation with respect to such income. Both the accumulated earnings tax (secs. 531 *et seq.*) and the personal holding company tax (secs. 541 *et seq.*), while imposed at the corporate level, are designed to address this concern.

extent that this is viewed as inappropriate, imposing taxation at the shareholder rather than the entity level provides a convenient means of ensuring that no such "double taxation" will occur.

While it may be feasible to integrate taxation on distributed earnings even if the entity is treated as a separate taxable unit, the means of doing so may involve either complexity, or the possibility of manipulation or anomalous results. For example, excluding dividends from the taxable income of recipients may create incentives for taxpayers to invest in the form of equity rather than debt. Allowing a dividends paid deduction may involve some complexity if it were desired to deny relief to foreign or tax-exempt entities. Shareholder credits (reducing the tax on dividends received to reflect taxes paid at the entity level) may require additional accounting. In all of these cases, questions may arise regarding the treatment at the owner level with respect to tax preferences realized by the entity (e.g., for purposes of the minimum tax). It can be argued that imposing tax at the owner rather than the entity level is more feasible, at least under certain circumstances, than adopting any of these approaches.

II. SUMMARY OF THE BILLS

1. H.R. 1658— Messrs. Guarini, Stark, and Frenzel

Tax Treatment of Business Development Companies

Present law

Under present law, a business development company may not qualify as a regulated investment company unless it registers with the S.E.C under the Investment Company Act of 1940, or is exempt from such registration requirement.

H.R. 1658

Under H.R. 1658, a "business development company" would be permitted to qualify as a regulated investment company and receive conduit treatment, without registration under the Investment Company Act of 1940. A business development company under the bill, generally is a company that qualifies as a business development company under the Investment Company Act of 1940.

The bill would be effective for taxable years beginning on or after October 21, 1980.

2. H.R. 2571—Messrs. Vander Jagt, Stark, Matsui, and Archer

Tax Treatment of Real Estate Investment Trusts

Present law

Under present law, a REIT must compute its earnings and profits using straight line depreciation, over a period of time longer than the recovery period for computing taxable income. REITs are subjct to the corporate minimum tax under present law.

REITs are required to perform services provided in connection with the rental of property through an independent contractor under present law. Present law provides a safe harbor from the prohibited transactions rule for REITs.

The amount of capital gains dividends that a REIT may pay in a taxable year is equal to the REIT's net capital gain reduced by the amount of any net operating loss of the REIT. REITs are required to file notices of their capital gains dividends within 30 days of the end of the taxable year.

REITs may not be closely held under present law. In addition, REITs generally may not hold assets in wholly owned subsidiaries under present law.

A REIT's distribution requirement under present law is based on its taxable income without regard to whether the REIT has received any cash.

REITs are subject to an excise tax on certain distributions made after year end, and to certain penalties on deficiency dividends.

H.R. 2571

Under H.R. 2571, several modifications would be made to the taxation of real estate investment trusts and their shareholders.

Under the bill, a REIT could elect to use the same amount of depreciation used in computing its taxable income for the purpose of computing its earnings and profits. REITs also would not be subject to the corporate minimum tax.

The bill would eliminate the requirement that services must be provided through an independent contractor for properties in which the REIT has less than a 20 percent interest. The bill also would expand the safe harbor under which sales are not treated as prohibited transactions.

Under the bill, the amount of capital gains dividends that a REIT would be permitted to pay would be limited to the amount of its net capital gain for the year, without reduction for the amount of any net operating loss carryovers, and the time for filing capital gains notices would be extended to 45 days.

Under the bill, a REIT would be permitted to be closely held in its first year as a REIT, and attribution of ownership of stock from partners would be ignored in determining whether a REIT is closely held thereafter. REITs would be permitted to hold assets in wholly owned subsidiaries under the bill.

The bill would reduce the amount that a REIT is required to distribute by the amount of income that a REIT is required to recognize from certain loans, leases, and exchanges without receiving cash.

The bill would eliminate the excise tax on certain dividends paid after the close of the taxable year, and also would eliminate certain penalties applicable to the distribution of deficiency dividends.

The bill would be effective as of the date of enactment.

3. H.R. 3397—Mr. Flippo, Mrs. Kennelly, Messrs. McGrath, Heftel, Anthony, Campbell, Daub, Crane, Schulze, Matsui, Thomas of California, and Vander Jagt

Tax Treatment of Regulated Investment Companies

H.R. 3397 would make certain modifications to the treatment of regulated investment companies ("RICs").

Under the bill, the limitation on the amount of gains that a a RIC may realize from the sale of stock or securities held for less than three months would be eliminated.

The bill also would clarify the assets that a RIC is permitted to invest in and would include foreign currency in certain circumstances.

The bill also would clarify the treatment of so-called "series funds," and also would modify certain reporting and compliance provisions.

4. H.R. 4448—Messrs. Pickle, Vander Jagt, and Duncan

Tax Treatment of Entities Owning Real Estate Mortgage Loans

Present law

Under present law, income producing assets, such as home mortgages, may be owned directly by individuals, or may be owned indirectly by means of ownership in a corporation or beneficial interest in a trust that holds such assets. If such obligations are held by a corporation or as an association taxable as a corporation, income tax may be imposed at both the corporate and individual levels on the income generated by such assets.

Under present law, the grantor of a "grantor trust" is treated as the owner of the assets held by the trust. Under Treasury regulations, a trust that has more that one class of interests (e.g., if certain beneficiaries receive distributions of principal before ther beneficiaries) is treated as an association taxable as a corporation, and not as a grantor trust.

The application of the present law rules relating to the treatment of original issue discount and market discount with respect to debt obligations that are prepaid is somewhat uncertain.

H.R. 4448

H.R. 4448 would provide rules under which an entity that holds debt obligations, generally limited to mortgages on real property, could issue interests that entitle holders to receive specified cash flows generated by the mortgages, without the imposition of a corporate tax on the entity. Under the bill, such interests would be known as "collateralized mortgage securities" or "CMSs." CMSs could be issued by a corporation, trust, or partnership, and could be in the form of an ownership interest or a debt obligation. CMSs could be issued with different classes of maturities. Holders of the interests would be treated as owners of the underlying mortgages.

The bill also would prescribe rules for the taxation of holders of CMSs, including clarification of the application of the original issue discount and market discount rules to obligations whose maturity may be accelerated because of prepayments on the underlying obligations. The bill also would expand the reporting requirements of present law.

The bill generally would apply to CMSs and debt obligations issued after the date of enactment.

III. DESCRIPTION OF THE BILLS

1. H.R. 1658—Messrs. Guarini, Stark, and Frenzel

Tax Treatment of Business Development Companies

Present Law

A regulated investment company is permitted a deduction for capital gain dividends and ordinary income dividends paid to its shareholders if it meets several tests. Among other requirements, a regulated investment company must be registered with the Securities and Exchange Commission at all times during the taxable year as a management company or unit investment trust under the Investment Company Act of 1940, or it must be a common trust fund or similar fund that is not included in the term "common trust fund" under the Internal Revenue Code and that is excluded by the Investment Company Act from the definition of investment company (Code sec. 851(a)). In order to register under the Investment Company Act of 1940, a corporation must have at least 100 stockholders or must be making or presently proposing to make a public offering.

Under the Small Business Incentive Act of 1980 (P.L. 96-477), certain investment companies providing capital and managerial assistance to small business may elect to be treated as "business development companies" in lieu of registering under the Investment Company Act.

A small business investment company operating under the Small Business Investment Act of 1958 is eligible to be treated as a regulated investment company if it meets the applicable requirements, including the requirement of registering under the Investment Company Act.

A less stringent diversification requirement than is generally applicable for qualification for RIC status applies to certain investment companies that furnish capital to corporations engaged in the development of new inventions, technologies, etc. (sec. 851(e)). Business development companies often qualify for this exception.

Issue

The issue raised by the bill is whether the provisions of the Small Business Incentive Act permit the corporation to engage in activities that are sufficiently more active than those permitted under the Investment Company Act such that conduit treatment would not be appropriate.

Explanation of the Bill

Under the bill, a "business development company" (as defined in the bill) would not be prevented from qualifying as a regulated investment company by the fact that the company did not register under the Investment Company Act. The bill defines a business development company as a domestic corporation other than a personal holding company (or a corporation that would be a personal holding company but for the exception for certain small business investment companies) that is a business development company under the Investment Company Act, as amended.

The bill would enable a company electing to be treated as a "business development company" under the Investment Company Act to qualify as a regulated investment company notwithstanding the fact that it does not register under the Investment Company Act.

Effective Date

The bill would apply to taxable years beginning on or after October 21, 1980.

2. H.R. 2571—Messrs. Vander Jagt, Stark, Matsui, and Archer

Tax Treatment of Real Estate Investment Trusts

Present Law

Overview

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT is subject to a corporate tax only on the income that it retains, on certain income from property that qualifies as foreclosure property, and income from prohibited transactions. Thus, the REIT may serve as a means whereby numerous small investors can have a practical opportunity to invest in a diversified portfolio of real estate assets and have the benefit of professional management.

In order to qualify as a REIT and thereby receive conduit treatment, an entity must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the active operation of business involving real estate. In addition, substantially all of the entity's income must be distributed to its shareholders on a current basis.

Taxation of REITs

In general

In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its "real estate investment trust taxable income" ("REITTI"), and also is taxable on certain other amounts. REITTI is the taxable income of the REIT with certain adjustments. The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for Federal income tax purposes. In arriving at REITTI, net income (or loss) from prohibited transactions (described below) is excluded (or added).

Capital gains

A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain in the same manner that capital gains are taxed to corporations generally (i.e., an alternative capital gains tax). However, the REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a "capital gain dividend" to its shareholders. A capital gain dividend is any dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders within 30 days after the end of the taxable year in which the dividend is paid. Shareholders who receive capital gain dividends treat the amount of such dividends as long-term capital gain regardless of their holding period of the stock.

The amount of dividends that a REIT may designate as capital gain dividends may not exceed its REITTI for the taxable year (determined without regard to the dividends paid deduction). The practical effect of this limitation is that any net operating losses of the REIT will offset the amount of income eligible for preferential capital gain treatment. Such offsetting is the normal rule for corporations that have both capital gains and net operating losses. However, this offsetting results in less income receiving capital gains treatment in the hands of the REIT's shareholders than would be the case if an individual had both capital gains and net operating losses, because individuals are afforded an exclusion for a portion of their capital gains, rather than an alternative tax.

Income from foreclosure property

A REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property. In general, foreclosure property is any real property or personal property incidental to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property. A REIT is required to operate foreclosure property through an independent contractor after the 90 day period following the acquisition of such property by the REIT.

Income or loss from prohibited transactions

In general, a REIT is intended to be an entity that is not engaged in any active trade or business activities and that derives its income from passive sources. Accordingly, a 100 percent tax is imposed on the net income of a REIT from "prohibited transactions." A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Code (property held for sale in the ordinary course of a trade or business) other than foreclosure property. Thus, the 100 percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and does not engage in ordinary retailing activities. Net income or net loss from prohibited transactions is determined by aggregating all gains from the sale or other disposition of property (other than foreclosure property) described in section 1221(1) with all losses and other deductions that are directly connected with the sale or other disposition of such property.

A safe harbor is provided for certain sales which might otherwise be considered prohibited transactions. Under this safe harbor, a sale is not considered to be a prohibited transaction provided that the REIT makes no more than 5 sales during the taxable year and improvements made by the REIT in the four years preceding sale that are includible in the basis of the property do not exceed 20 percent of the selling price of the property.

Organizational structure requirements

In order to qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees. The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership held by 100 or more persons. The entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income.[28] The entity must be a calendar year taxpayer unless it was in existence as a REIT for any taxable year beginning prior to October 4, 1976. Certain financial institutions and life insurance companies may not qualify as REITs.

Income requirements

In general

In general, in order to meet the income requirements applicable to REITs, at least 75 percent of the entity's income (excluding gross income from prohibited transactions) must be from rents from real property, interest on obligations secured by mortgages on real property or on interests in real property, gain from the sale or other disposition of real property, dividends or distributions from another REIT, gain from the disposition of interests in a REIT, abatements or refunds of taxes on real property, and income or gain derived from property that qualifies as foreclosure property.

In addition, at least 95 percent of the entity's gross income (excluding gross income from prohibited transactions) must be derived from the sources qualifying for the 75 percent test or from other interest, dividends, or gains from the sale of stock or securities. Less than 30 percent of the entity's gross income may be derived from gain from the sale or other disposition of stock or securities held for less than the applicable holding period for long term capital gain or loss treatment, real property held less than 4 years (other than foreclosure property, or property subject to an involuntary conversion within the meaning of section 1033), and property that is sold or disposed of in a prohibited transaction.

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[28] A corporation at least 50 percent of whose stock is held directly or indirectly by or for five or fewer individuals at any time during the last half of its taxable year is treated as a personal holding company if at least 60 percent of its ordinary adjusted gross income for the taxable year comprises personal holding company income (sec. 542). The REIT is required to keep records for the purpose of determining actual ownership of interests in the entity for this purpose. *See* Treas. Reg. sec. 1.857-8.

Definition of rents from real property

In general.—For purposes of the income requirements, rents from real property generally include rents from interests in real property, charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated, and rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15 percent of the total rent for the year under the lease.

Amounts are not treated as rents from real property, however, if the amount of such rent is determined in whole or in part on the net income or profits derived by any person from the use of such property. Rents based on a fixed percentage of gross receipts or sales do not violate this requirement, however.[29] In addition, amounts are not treated as qualifying rent if received from certain parties in which the lessor has an interest of 10 percent or more. Further, where the entity furnishes or renders services to the tenants of rented property, amounts received or accrued with respect to such property are not treated as qualifying rents unless the services are furnished through an independent contractor. In general, an independent contractor is a person who does not own more than a 35 percent interest in the REIT, and in which no more than a 35 percent interest is held by persons with a 35 percent or greater interest in the REIT.

Customary services.—In general, services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings that are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance, and of janitorial and cleaning services, the collection of trash, the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services that are customarily furnished to tenants of a particular class of buildings in many geographical marketing areas (Treas. Reg. sec. 1.856-4(b)).

Asset requirements

In order to satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and Government securities. Certain diversification requirements prevent the REIT from having too great a percentage of its assets invested in the securities of any one issuer. The term "real estate assets" is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs.

[29] Similar rules apply in determining whether interest income is treated as qualifying income.

Distribution requirement

General rule

In order to satisfy the distribution requirement, an entity must distribute as dividends to its shareholders during the taxable year an amount equal to at least the excess of (1) the sum of (a) 95 percent of its REITTI other than capital gains income, and (b) 95 percent of the entity's net income from foreclosure property less the tax imposed on such income, over (2) the sum of (a) penalty taxes imposed under section 6697 (resulting from the distribution of "deficiency dividends") and (b) the net loss from prohibited transactions.

Distributions after the taxable year

Certain distributions within 12 months of the end of the taxable year.—If a REIT declares a dividend prior to the time for filing its tax return for a taxable year and actually pays such dividend within 12 months of the end of such taxable year (but not later than the date of the next regular payment after the declaration of the dividend), then the REIT may elect to have the dividend treated as having been paid in the preceding taxable year (sec. 858). Notwithstanding the election, the distributees are treated as having received the dividend in the year in which the distribution is made.

To partially compensate for the deferral of tax liability that may occur where a REIT pays such so-called "section 858 dividends," a nondeductible three percent excise tax is imposed on a portion of such dividends.

Other distributions after the end of the taxable year—deficiency dividends.—Where, as a consequence of an audit by the Internal Revenue Service, there has been a "determination" that an "adjustment" is to be made to REITTI for a taxable year, the entity may pay a deficiency dividend to its shareholders and receive a deduction for such distributions with regard to the taxable year for which the election is made, provided that the adjustment did not occur as a result of fraud or willful failure to file a Federal income tax return. If the proper amount is distributed as a deficiency dividend, the entity is not disqualified as a REIT or subject to tax on the amounts distributed (but is subject to interest and penalties). Interest and penalties relating to amounts distributed as deficiency dividends are based on the amount of the adjustment.

In addition to other penalties provided under the Code relating to underpayments of tax, section 6697 of the Code imposes a penalty equal to the amount of interest attributable to the amount paid by a REIT as a deficiency dividend. The amount of this penalty is limited to one half of the amount of the deficiency dividend.

Issues

First, is it appropriate to modify the rules relating to earnings and profits to better enable REITs to pay nontaxable return of capital dividends to its shareholders? Second, is it appropriate to except REITs from the corporate minimum tax?

Is it appropriate to allow REITs to pay capital gains dividends where the amount of their net capital gain otherwise would be offset by net operating losses? Should the period for distributing capital gain dividend notices be extended from 30 to 45 days?

To what extent should REITs be permitted to earn profits in connection with the provision of services to tenants or other services in connection with the rental of real property, through the elimination of the independent contractor requirement?

To what extent should REITs be permitted to make sales of property that would be treated as sales to customers in the ordinary course of business without being subject to the tax on prohibited transactions?

Is it appropriate to eliminate the excise tax on distributions after the close of the REIT's taxable year and the penalty tax under section 6697 on deficiency dividends?

Is it appropriate to allow REITs to hold property in wholly owned subsidiaries?

Is it appropriate to allow REITs to receive rents based on the net income of a tenant substantially all of whose income consists of rents from subtenants that are not based on the subtenants' profits?

Should a REIT's distribution requirement be based on the REIT's taxable income or on the amount of cash it receives?

Explanation of the Bill

Overview

The bill would modify many of the provisions relating to the requirements for qualification as and the taxation of REITs. The provisions that would be modified relate to the general requirements for qualification as a REIT, the computation of the earnings and profits of a REIT, the income and asset requirements for qualification as a REIT, the definition of rents from real property and interest, the distribution requirement for qualification as a REIT, the treatment of capital gains, the provisions relating to prohibited transactions, and certain other provisions.

General requirements

Under the bill, as under present law, an entity generally may not elect REIT status if it would meet the stock ownership test of section 542(a)(2) (i.e., if it would be treated as a personal holding company if all of its income constituted personal holding company income). Under the bill, however, for the first full taxable year following the registration of the entity's shares under the Securities Act of 1933, an entity that otherwise meets the applicable requirements may elect REIT status notwithstanding its failure to meet the section 542(a)(2) stock ownership test. In addition, attribution to an individual of stock owned by or for the individual's partner would be ignored under the bill in applying the attribution rules of section 544 for purposes of determining whether the stock ownership requirement of section 542(a)(2) is met for any taxable year.

Income and asset requirements

The bill would add "REIT subsidiaries" to those assets that are included in the 75 percent asset test for a REIT. Under the bill, a REIT subsidiary would be a corporation all of the shares of which are owned by a REIT. REIT subsidiaries generally would be ignored for all Federal income tax purposes under the bill, i.e., the REIT subsidiaries would not be treated as separate taxpayers, and all tests for qualification as a REIT would be made on a combined basis.

Definition of rents from real property and interest

Independent contractor requirement

Under the bill, amounts received by a REIT in connection with the rental of property in which the REIT has an interest of less than 20 percent would not fail to qualify as rents from real property where services are performed in connection with the rental of the property other than through an independent contractor. In addition, the requirement that foreclosure property be operated through an independent contractor after more than 90 days following the acquisition of the property by the REIT would be eliminated.

Rents and interest based on net income

Under the bill, rents or interest that are based on the net income of a tenant or debtor would be treated as rent from real property or as interest, respectively, if certain conditions are met. In order to qualify, the rent (or interest) would have to be received from a tenant (or debtor) that receives substantially all of its income from the leased property (or the property that secures the loan) from the subleasing (or leasing) of substantially all of such property, and the tenant (or debtor) would have to receive or accrue directly or indirectly from the subleasing (or leasing) of the property only amounts that are not based on the net profits of any person.

Distribution requirement

Under the bill, the minimum amount that the REIT is required to distribute (i.e., the minimum dividends paid deduction as specified in section 857(a)(1)) would be reduced by a portion of certain amounts that the REIT is required to include in income in advance of receiving cash. These amounts would be the excess of the sum of (1) amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, and (2) the amount of original issue discount that the REIT is required to accrue with respect to a loan arising from the sale of property to which section 1274 applies, over (3) the amount of money and the fair market vaue of other property received during the taxable year with respect to such transactions from which such income was derived. The distribution requirement also would be reduced by the amount of income arising from the disposition of a real estate asset, but only in circumstances where such income is recognized pursuant to a determination that such disposition was not part of a tax-free exchange within the meaning of sec-

tion 1031, and failure to meet the requirements of section 1031 was due to reasonable cause and not due to willful neglect.

Modification of earnings and profits rules

Under the bill, a REIT would be permitted to elect to compute its earnings and profits with respect to property eligible to be depreciated under the Accelerated Cost Recovery System, using the actual depreciation allowed, rather than the smaller amounts required under the rules applicable to computing earnings and profits (section 312(k)(3)). Hence, under the bill, a REIT would be able to distribute amounts that would be treated as nontaxable returns of capital to the REIT's shareholders, which amounts are treated as taxable dividends under present law. To the extent that a REIT shareholder receives amounts that would not be treated as return of capital but for the election under the bill, amounts received on the sale or exchange of the shareholder's shares in the REIT would be treated as ordinary income.

In addition, the bill would provide that the amount of a REIT's current (but not accumulated) earnings and profits for a taxable year would not be less than its REITTI (determined without regard to the dividends paid deduction) for the taxable year.

Capital gains

Under the bill, for purposes of determining the maximum amount of capital gains dividends that a REIT may pay for a taxable year, the REIT would not offset its net capital gain with the amount of any net operating loss carried over from a previous taxable year. In addition, the time for mailing of so-called capital gain notices would be extended from 30 to 45 days after the close of the taxable year.

Prohibited transactions rules

The bill would make two modifications to the rules relating to prohibited transactions. First, the bill would modify the safe harbor under which sales by the REIT meeting the conditions of the safe harbor are not treated as prohibited transactions. Under the bill, the number of sales of property that a REIT may make within the safe harbor would be increased from five to ten. In addition, the extent of expenditures that the REIT may make within four years of sale that are includible in the basis of the property is increased from 20 percent of the net selling price of the property to 30 percent.

The bill also would provide that sales of cooperative or condominium units in a property held by the REIT for the production of rental property for at least four years, generally would be aggregated and treated as one sale for the purpose of applying the safe harbor. Thus, under the bill, a REIT would be permitted to derive gains from the sale of property that is held for sale to customers in the ordinary course of its business, without being subject to the 100 percent tax on prohibited transactions.

Second, the bill would provide that, in determining REITTI, the amount of any net loss from prohibited transactions may be taken into account.

Deficiency dividends

Under the bill, the maximum amount of the penalty tax under section 6697 would be limited to the lesser of 50 percent of the amount of the distribution, 5 percent of REITTI with certain adjustments, or one half of one percent of the the value of the assets of the REIT.

Section 858 dividends

Under the bill, no excise tax would be imposed under section 4981 for any dividend that is paid within 90 days of the close of the taxable year. Thus, under the bill, all of a REIT's income for a taxable year could be distributed and accounted for by shareholders in the following taxable year without any tax being collected in the year the income was earned and without penalty.

Corporate minimum tax

The bill would exempt REITs from the corporate minimum tax provisions of section 291.

Effective date

The bill would be effective as of the date of enactment.

Senate Finance Committee Bill

Overview

On May 29, 1986, the Senate Finance Committee reported H.R. 3838, the Tax Reform Act of 1986,[30] (the "SFC bill"), which included several provisions relating to REITs, many of which are similar to provisions of H.R. 2571. In general, sections 1431–1438 of the SFC bill would modify many of same provisions that would be modified by H.R. 2571, including provisions relating to the general requirements for qualification as a REIT, the income and asset requirements for qualification as a REIT, the definition of rents from real property and interest, the distribution requirement for qualification as a REIT, the treatment of capital gains, the provisions relating to prohibited transactions, and certain other provisions.

General requirements

Under the SFC bill, as under present law, an entity generally could not elect REIT status if it meets the stock ownership test of section 542(a)(2) (i.e., if it would be treated as a personal holding company if all of its income constituted personal holding company income) or if it had fewer than 100 shareholders. Under the bill, however, an entity that otherwise meets the applicable requirements would be permitted to elect REIT status notwithstanding its meeting the section 542(a)(2) stock ownership test or its having fewer than 100 shareholders, provided that the entity was not a REIT in any prior year. In applying the attribution rules of section 544 for purposes of determining whether the stock ownership requirement of section 542(a)(2) is met for any taxable year, attribu-

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[30] Sen. Rept. No. 99-313, 99th Cong. 2d Sess.

tion to an individual of stock owned by or for the individual's partner would be ignored under the SFC bill.

The SFC bill would provide that, in order to elect REIT status, the electing entity must either have been treated as a REIT for all taxable years beginning after February 28, 1986, or must have no earnings and profits accumulated for any year in which the entity was in existence and not treated as a REIT. The SFC bill also would provide that an entity that has not engaged in any active trade or business would be permitted to change its annual accounting period to a calendar year without approval of the Internal Revenue Service in connection with electing REIT status.

Income and asset requirements

REIT subsidiaries

Under the SFC bill, all the assets, liabilities, and items of income, deduction, and credit of a "qualified REIT subsidiary" would be treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT would be treated as a qualified REIT subsidiary if and only if 100 percent of the subsidiary's stock is owned by the REIT at all times that the subsidiary is in existence. If at any time the REIT ceases to own 100 percent of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary would be treated as a new corporation that acquired all of its assets in exchange for its stock (and the assumption of liabilities) immediately before the time that the REIT ceased to own 100 percent of the subsidiary's stock, or ceased to be a REIT as the case may be.

New equity capital

Under the SFC bill, if a REIT receives new equity capital, then income derived from stock or debt instruments (i.e., interest, dividends, or gains from the sale of such stock or debt instruments) that is attributable to the temporary investment of the new equity capital would be treated, for a one-year period beginning on the date that the REIT receives such capital, as qualifying income for purposes of the "75 percent income test." In addition, during such period, stock or debt instruments purchased with such capital would be treated as "real estate assets" for purposes of the "75 percent asset test." Under the SFC bill, new equity capital would be any amount received by the REIT in exchange for stock of the REIT (other than pursuant to a dividend reinvestment plan).

Definition of rents and interest

Independent contractor requirement

Under the SFC bill, amounts received by a REIT in connection with the rental of property would not fail to qualify as rents from real property merely because the REIT performs certain services and does not use an independent contractor for the provision of such services. Under the SFC bill, the services that may be provided without violating the "independent contractor test" would be those services the provision of which would not by reason of section

512(b)(3) result in the receipt of "unrelated business income" by an organization subject to tax on such income (sec. 511(a)(2)). Thus, under the SFC bill, amounts received by the REIT in connection with the rental of real property would not fail to be treated as rents from real property if the REIT provides only certain services other than services that are considered rendered to the occupant of the property (Treas. Reg. sec. 1.512(b)-1(c)(5)).

Rents and interest based on net income

Under the SFC bill, rents or interest that are based on the net income of a tenant or debtor would be treated as rent from real property or as interest, respectively, if certain conditions are met. To qualify, the rent (or interest) must be received from a tenant (or debtor) that receives substantially all of its income from the leased property (or the property that secures the loan) from the subleasing (or leasing) of substantially all of such property, and the rent received by the tenant (or debtor) must consist entirely of amounts that would be treated as rents from real property (or interest) if received directly by the REIT.

Distribution requirement

Under the SFC bill, the minimum amount that the REIT is required to distribute (i.e., the minimum dividends paid deduction as specified in section 857(a)(1)) would be reduced by a portion of certain amounts that the REIT is required to include in income in advance of receiving cash. These amounts are (1) amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, (2) the amount of original issue discount that the REIT is required to accrue with respect to a loan arising from the sale of property to which section 1274 applies, and (3) any income arising from the disposition of a real estate asset, but only in circumstances where the REIT had entered into a transaction with respect to such real estate, had intended in good faith that the transaction qualify as a like-kind exchange under section 1031, the income is recognized as a result of a determination that the transaction did not so qualify, and the failure to meet the requirements of section 1031 was due to reasonable cause and not due to willful neglect. The portion of such amounts by which the REIT's minimum distribution requirement would be reduced is the amount by which the sum of these amounts exceeds five percent of the REITTI of the REIT determined without regard to the REIT's dividends paid deduction and net capital gain.

In addition, the SFC bill would provide that the amount of a REIT's current (but not accumulated) earnings and profits for a taxable year is to be not less than its REITTI (determined without regard to the dividends paid deduction) for the taxable year.

Capital gains

Under the SFC bill, for purposes of determining the maximum amount of capital gains dividends that a REIT may pay for a taxable year, the REIT would not offset its net capital gain with the amount of any net operating loss, whether current or carried over from a previous taxable year. To the extent that the REIT then

elects to pay capital gains dividends in excess of its net income, the REIT would increase the amount of its net operating loss carryover by such amount.

Under the SFC bill, REITs would be permitted to mail the required capital gain notices to shareholders with the REIT's annual report rather than within 30 days of the end of the REIT's taxable year.

Prohibited transactions rules

The SFC bill would make two modifications to the rules relating to prohibited transactions. First, the SFC bill would modify the safe harbor under which sales by the REIT meeting the conditions of the safe harbor are not treated as prohibited transactions. Under the SFC bill, the number of sales of property that a REIT may make within the safe harbor would be increased from five to seven. In addition, the extent of expenditures that the REIT may make within four years of sale that are includible in the basis of the property would be increased from 20 percent of the net selling price of the property to 30 percent. The SFC bill also would provide an alternative safe harbor whereby the REIT may make any number of sales of real property during the taxable year, provided that the gross income from such sales does not exceed 15 percent of the REITTI of the REIT for the taxable year. A sale would be treated as qualifying for the alternative safe harbor, however, only if substantially all the marketing and development expenditures with respect to the property sold were made through an independent contractor.

Second, the SFC bill would provide that, in determining the amount of net income derived from prohibited transactions, losses from prohibited transactions (and deductions attributable to prohibited transactions in which a loss was incurred) would not be taken into account. The SFC bill would provide, however, that the the amount of any net loss from prohibited transactions may be taken into account in computing REITTI.

Deficiency dividends

Under the SFC bill, the penalty tax under section 6697 on deficiency dividends would be repealed.

Effective date

The provisions of the SFC bill generally would be effective for taxable years beginning after December 31, 1986.

3. H.R. 3397—Mr. Flippo, Mrs. Kennelly, Messrs. McGrath, Heftel, Anthony, Campbell, Daub, Crane, Schultz, Matsui, Thomas of California, and Vander Jagt

Tax Treatment of Regulated Investment Companies

Present Law

Overview

Conduit treatment similar to that granted to REITs also is provided to regulated investment companies ("RICs"). In general, a RIC is an electing domestic corporation that either meets or is excepted from certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), and that meets certain other requirements that are intended to assure that the RIC is an essentially passive entity that invests mostly in a diversified portfolio of stocks and securities, that derives most of its income from these sources, and that distributes most of its income to its shareholders annually.

Taxation of the RIC

In general

In general, if an entity qualifies as a RIC by satisfying the various requirements described below, the entity is taxable at the highest rate of tax applicable to corporations on its "investment company taxable income." Investment company taxable income generally is the taxable income of the RIC with certain adjustments. The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the RIC becomes a conduit for Federal income tax purposes.

Capital gains

A RIC that has a net capital gain for a taxable year generally is subject to tax on such capital gain in the same manner as capital gains are ordinarily taxed (i.e., the alternative capital gains tax). However, the RIC may diminish or eliminate its tax liability attributable to such capital gain by paying a "capital gain dividend" to its shareholders. A capital gain dividend is any dividend or part of a dividend that is designated by the payor RIC as a capital gain dividend in a written notice mailed to shareholders within 45 days after the end of the taxable year in which the dividend is paid. Shareholders who receive capital gain dividends treat the amount of such dividends as long-term capital gain regardless of their holding period of the stock.[31] If the RIC does not distribute such capital

[31] Where a shareholder disposes of the RIC shares and incurs a short-term capital loss, such loss may be recharacterized as a long-term loss to the extent of capital gains dividends received, however.

gains dividends, shareholders are deemed to have received the undistributed capital gain as a capital gain dividend, and are deemed to have paid tax on such amount equal to the tax paid by the RIC attributable to the undistributed capital gain.

Income and asset requirements

In order to qualify as a RIC, an entity must derive 90 percent of its gross income from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities. In addition, at least 50 percent of the entity's assets at the close of each quarter must be represented by cash and cash items, government securities, securities of RICs, and other securities, provided that certain diversification requirements are met.

Limitation on short-term gains

One of the rules of present law intended to assure that a RIC does not actively engage in the business of trading securities requires that an entity may qualify as a RIC only if less than 30 percent of its gross income is derived from the sale or other disposition of securities held for less than three months.

Distribution requirement

In general

In order to qualify as a RIC, an entity must distribute at least 90 percent of its investment company taxable income (determined without regard to the dividends paid deduction), and at least 90 percent of its net tax exempt interest income.

Distributions after the close of the year

If a RIC declares a dividend prior to the time for filing its tax return for a taxable year and actually pays such dividend within 12 months of the end of such taxable year (but not later than the date of the next regular payment after the declaration of the dividend), then the RIC may elect to have the dividend treated as having been paid in the preceding taxable year (sec. 858). Notwithstanding the election, the distributees are treated as having received the dividend in the year in which the distribution is made.[32]

In addition, where, as a consequence of an audit by the Internal Revenue Service, there has been a "determination" that an "adjustment" is to be made to investment company taxable income for a taxable year, the RIC may pay a deficiency dividend to its shareholders and receive a deduction for such distributions with regard to the taxable year for which the election is made, provided that the adjustment did not occur as a result of fraud or willful failure to file an income tax return. If the proper amount is distributed as a deficiency dividend, the entity is not disqualified as a RIC or subject to tax on the amounts distributed (but is subject to interest and penalties). Interest and penalties relating to amounts distributed as deficiency dividends are based on the amount of the adjustment.

[32] Under H.R. 3838 as reported by the Senate Finance Committee on May 29, 1986, a nondeductible 5-percent excise tax would be imposed on the amount of such dividends.

Background and Issues

In general, conduit treatment for a RIC may be justified on the ground that a RIC is essentially an entity that engages in no active trade or business and that receives income from only passive sources. Several of the requirements for qualification as a RIC help assure this passivity. Registration under the Investment Company Act of 1940, for example, limits the activities that the RIC may engage in. The requirement that most of its assets must be, and most of its income derived from, stocks or securities assure that the RIC can engage in no business unrelated to investing in stock or securities. This assurance is bolstered by the diversification requirement, which assures that in most cases the RIC could not exercise managerial authority by virtue of substantial stock ownership. Further, the limitation on the amount of "short-short" gains prevents significant amounts of the active trading of securities by the RIC.

The issues raised by the bill are as follows.

Should one of the requirements relating to the passivity of a RIC, the limitation on the ability of a RIC to derive "short-short" gains, be eliminated?

Should income and assets from foreign currency transactions be treated as qualifying income and assets for RIC purposes?

Should a single entity be permitted to establish separate classes of interests that would be treated as separate RICs for Federal income tax purposes?

Should the period for filing capital gains notices be extended from 45 to 60 days?

Explanation of the Bill

The bill would amend certain provisions of the Internal Revenue Code relating to the taxation of regulated investment companies.

First, the bill would repeal the requirement that, in order to qualify as a RIC, the entity must derive less than 30 percent of its income from gains from the sale or other disposition of stock or securities held for less than 3 months. By repealing this requirement, often referred to as the "short-short" rule, the bill would enable a RIC to undertake unlimited trading activities in stocks and securities, while still enjoying conduit treatment.

Second, the bill would expand the definition of permitted income for a RIC to include income from foreign currencies, or other income (including but not limited to gains from options or futures contracts) derived with respect to the RIC's business of investing in stock, securities, or currencies. This provision would allow RICs to invest in foreign currencies in order to hedge investments in stocks or securities denominated in foreign currencies, but also would allow RICs to undertake broader forms of investing in foreign currencies. In addition, the bill would provide that the term "securities" would have the same meaning as specified in section 2(a)(36) of the Investment Company Act of 1940, as amended.

Third, the bill would provide that where a RIC maintains separate funds, each fund of the RIC would be treated as a separate corporation. For this purpose, a separate fund is a segregated portfolio of assets, the beneficial ownership in which is owned by the

holder of a class of series of stock in the RIC that is preferred over all other classes or series in respect of such portfolio of assets. Thus, under the bill, if a RIC had several separate funds, the applicable requirements for RIC status would have to be met for each separate fund, and other rules relating to RICs also would be applied separately. For example, each fund would have to meet the diversification requirement to qualify for RIC status, and each fund also would calculate separately the amount of capital gains dividends that it may pay as well as the amount of tax exempt interest dividends that it may pay.

Fourth, the bill would extend the period allowed for filing certain notices (relating to capital gains dividends and exempt interest dividends) from 45 days after the end of the RIC's taxable year to 60 days. Fifth, the bill would extend to RICS (and their agents) the protection of section 7609(a) (relating to summonses served on third-party record keepers).

Effective Date

The provisions of the bill generally would be effective for taxable years ending on or after September 30, 1985, except that the provisions relating to the treatment of series funds would apply to taxable years beginning after the date of enactment, and the provisions relating to third party summonses would apply to summonses served after the date of enactment.

4. H.R. 4448—Messrs. Pickle, Vander Jagt, and Duncan

Tax Treatment of Entities Owning Real Estate Mortgage Loans

Present Law

Taxation of alternative methods of owning income producing assets

Overview

Under present law, income-producing assets (such as mortgages on residential property or other debt instruments) can be owned directly, or they can be owned indirectly by means of an equity interest in an intermediary entity. Income generated by property that is owned directly generally is taxed to the owner of the property. Thus, in the case of property owned directly by an individual, income from such property is subject to only one level of taxation. Income from property owned indirectly may be subject to more than one level of taxation, i.e., tax may be imposed both at the level of the intermediary holder and the indirect owner.

Whether more than one level of tax is imposed where income producing property is held indirectly generally depends on whether the intermediary entity is treated for Federal income tax purposes (1) as a separate taxable entity (such as a corporation or an association taxable as a corporation), (2) as a complete conduit entity (such as a partnership or S corporation), or (3) as a partial conduit entity (such as a trust or real estate investment trust) under which income is not taxed to the entity to the extent it is currently distributed to the entity's owners.

Direct ownership of income producing assets

The most basic form of direct ownership of income producing assets is the holding of such assets by an individual. Where an individual owns income producing assets directly, the individual generally includes all income generated by the property, and deducts all items of expense related to the property. When the individual disposes of the property in a taxable transaction, the individual recognizes gain or loss, which may be capital gain or loss.

The holding of property in a grantor trust is treated for Federal income tax purposes as another form of direct ownership. A grantor trust is an arrangement under which legal title to property is transferred to a trustee, but the transferor retains certain powers over, or interests in, the trust so that the transferors are treated as retaining direct ownership of such property for Federal income tax

purposes (secs. 671-679). Thus, income, deductions, and credits of the grantor trust are attributed directly to the grantors.[33]

Indirect ownership of income producing assets

Separate entity treatment

If income producing property is held in a corporation, the income earned by the corporation generally is taxed to the corporation. In addition, when the after-tax earnings of a corporation are distributed to the corporation's stockholders as dividends, generally such earnings also are taxed to the stockholders. Nevertheless, interest on debt incurred by a corporation to finance the acquisition of income-producing assets generally is deductible to the corporation incurring the debt. To the extent that income from debt-financed property is paid to the debtholders in the form of interest, the interest deduction offsets any corporate-level tax on such income, resulting in the imposition of only a single tax on the income, which tax is borne by the debtholder.

Conduit treatment

If income producing property is held by a partnership, the partnership generally is treated as a complete conduit for Federal income tax purposes, and each partner accounts for his "distributive share" of the partnership's income, loss, deduction, and credit. The liability for income tax is that of the partner, and not of the partnership, without regard to whether the income of the partnership is actually distributed to the partners. Partnership losses, deductions, and credits pass through to the partners and can be used to offset other income.

If income producing property is held by an S corporation, notwithstanding the fact that the S corporation is a corporate entity, its shareholders generally may account for a proportionate amount of the corporation's items of income, loss, deduction, and credit under subchapter S of the Code (secs. 1361 *et seq.*). The S corporation itself generally has no tax liability for as long as the election is in effect.

Partial conduit treatment

Real estate investment trusts.—If income producing property is held by a real estate investment trust ("REIT"), the REIT generally is treated as a conduit for Federal income tax purposes to the extent of the amount of its earnings that are distributed currently to shareholders. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed on a current basis. Thus, income that is currently distributed to shareholders is not taxed at the REIT level; income that is not currently distributed to shareholders is taxed at the REIT level, as in the case of ordinary corporations.[34]

RICs.—If income producing property is held by a regulated investment company ("RIC"), conduit treatment similar to that

[33] In some cases, persons other than the transferors are treated as owners of the trust's assets.

[34] Requirements relating to the qualification as a REIT, and provisions relating to the taxation of REITs and their shareholders are discussed above in Part I.

granted to REITs is available. Thus, the RIC generally would account for its income separately, but would receive a deduction for income distributed to shareholders.[35]

Trusts.—Another form of indirect ownership of property is ownership of the beneficial interest of property that is held in a trust. A trust is an arrangement whereby trustees take title to property and become responsible for the protection and conservation of such property on behalf of the persons holding the beneficial interest in the property. A trust generally is treated as a partial conduit for Federal income tax purposes since the trust, although in form a separate taxable entity, is allowed a deduction for amounts distributed to its beneficiaries, which amounts generally are includible in the beneficiaries' income.

A fixed investment trust is a trust used to hold a diversified portfolio of investments for its beneficiaries. Generally, such a trust is treated as a trust for tax purposes (and not as an association) only if the trustee does not have the power to vary the investments of the trust, and the trust does not have more than one class of interests.[36]

Multiple class trusts

In May 1984, the Treasury Department issued proposed regulations addressing the treatment of trusts that have more than one class of ownership interest. Final regulations were issued in March 1985 (Treas. Reg. sec. 301.7701-4(c)(1)). Under these regulations, a trust is treated as having one class of ownership if all of the beneficiaries of the trust have undivided interests in all of the trust property. More than one class of ownership may exist where, for example, some beneficiaries are entitled to receive more than their pro rata share of trust distributions in early years and other beneficiaries are entitled to more than their pro rata share in later years.

Under the regulations, an arrangement having more than one class of ownership interest generally may not be treated as a trust, but is treated as a corporation. Thus, if a trust held a portfolio of mortgages, and interests in the trust assets were divided so that one class of beneficiaries were to receive all principal collected by the trust and a specified rate of interest thereon, until the trust had collected a specified amount of principal on the mortgages, and another class of beneficiaries were to receive all remaining amounts collected by the trust, then such trust would be treated as an association taxable as a corporation under the regulations. The regulations provide a limited exception for certain trusts with multiple classes, where the existence of multiple classes is incidental to the purpose of facilitating direct investment in the assets of the trust. The regulations apply to interests issued after April 27, 1984.

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[35] Requirements relating to the qualification as a RIC, and provisions relating to the taxation of RICs and their shareholders are discussed above in Part I.

[36] *See* discussion of entity classification, above.

Taxation of income from debt obligations

The original issue discount rules

Treatment of original issue discount as interest

If the borrower receives less in a lending transaction than the amount to be repaid at the loan's maturity, then the difference represents "discount." Discount performs the same function as stated interest, i.e., compensation of the lender for the use of the lender's money.[37] Code sections 1272 through 1275 and section 163(e) (the "OID rules") generally require the holder of a debt instrument issued at a discount to include annually in income a portion of the original issue discount ("OID") on the instrument, and allow the issuer of such an instrument to deduct a corresponding amount, irrespective of the methods of accounting that the holder and the issuer otherwise use.[38]

Definitions

"Original issue discount" is defined as the excess of a debt instrument's "stated redemption price at maturity" over its "issue price" (provided such excess is not less than a certain *de minimis* amount).

"Issue price" generally is (1) in the case of a cash loan, the amount borrowed, (2) in the case of a debt instrument that is issued for property where either the debt instrument or the property is publicly traded,[39] the fair market value of the property, or (3) if neither the debt instrument nor the property exchanged for it is publicly traded, an amount determined using an adequate interest rate.

"Stated redemption price at maturity" includes all amounts payable at maturity excluding any interest based on a fixed rate and payable unconditionally over the life of the debt instrument at fixed intervals no longer than one year.

Operation of the OID rules

The amount of the OID in a debt instrument, if any, is allocated over the life of the instrument through a series of adjustments to the issue price for each "accrual period." The accrual period generally is each six-month or shorter period ending on the calendar day corresponding to the date of the debt instrument's maturity and the date six months prior to the date of maturity.[40] The adjustment to the issue price for each accrual period is determined by multiplying the "adjusted issue price" (i.e., the issue price increased by adjustments prior to the beginning of the accrual

[37] *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965); *see also Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[38] Prior to 1982, the OID rules applied only to a limited class of obligations. The Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984 greatly expanded the number and types of obligations to which the OID rules apply.

[39] Presently, only stock or securities traded on an established securities market are treated as publicly traded. However, section 1503(a)(10) of H.R. 3838 as passed by the House, and section 1803(a)(10) of H.R. 3838 as reported by the Senate Finance Committee, would grant the Treasury Department authority to issue regulations treating as publicly traded other property "of a kind regularly traded on an established market."

[40] Under proposed regulations, different accrual periods may be required. *See* Prop. Treas. Reg. sec. 1.1272-1(d).

period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period.

The adjustment to the issue price for any accrual period is the amount of OID allocated to that accrual period. These adjustments reflect the amount of the accrued but unpaid interest on the debt instrument in each period. The holder is required to include this amount as interest income and the issuer is permitted a corresponding interest deduction. The holder's basis in the obligation is increased by the amount of OID includible in the holder's income.[41] Uncertainty exists about the application of the rules where the maturity of such payments may be accelerated (e.g., based on prepayments of home mortgages that collateralize the obligation).

Gain or loss on disposition or prepayment

In general, the sale or exchange of a debt obligation that is a capital asset results in the realization of a capital gain or loss to the seller. Under section 1271, amounts received by a holder of a debt obligation, other than one issued by an individual, on retirement of such debt obligation is treated as an amount received in exchange for the debt obligation. Thus, subject to certain exceptions discussed below, if a debt obligation not issued by an individual is a capital asset, its satisfaction, either at or in advance of its maturity, generally results in the realization of a capital gain or loss measured by the difference between the amount realized and the basis of the obligation. Since section 1271 does not apply to obligations issued by individuals, repayment of a debt obligation by an individual (including prepayment) is not treated as a sale or exchange, and thus may not give rise to capital gain or loss.[42]

Capital gain treatment also is unavailable if an obligation has original issue discount and, at the time of original issue, there was an intention to call the obligation before maturity. In general, in such a case, any gain realized on the sale or exchange (including the retirement by the issuer) of the obligation is treated as ordinary income to the extent that the gain does not exceed the amount of unamortized original issue discount (sec. 1271(a)(2)). There is no authority that directly addresses the application of this provision to corporate debt obligations that are issued with original issue discount and that are called prior to maturity upon the prepayment of mortgages in a pool that collateralizes the debt obligation.

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[41] The premise of the OID rules is that, for Federal income tax purposes, an obligation issued at a discount should be treated like an obligation issued at par requiring current payments of interest. Accordingly, the effect of the OID rules is to treat the borrower as having paid semiannually to the lender the interest accruing on the outstanding principal balance of the loan, thereby permitting the borrower to deduct as interest expense and requiring the lender to include in income such interest which has accrued but is unpaid. The lender then is deemed to have lent the accrued but unpaid interest back to the borrower, who in subsequent periods is deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the "economic accrual" of interest, or interest "compounding."

[42] *See* sec. 1271(b)(1). In addition, obligations issued before July 2, 1982, by an issuer other than a corporation or a government (or political subdivision thereof) do not qualify for capital gains treatment. *See* sec. 1271(b)(2).

The market discount rules

The availability of capital gain treatment on the sale or exchange of a debt obligation also may be limited pursuant to the so-called "market discount" rules. In general, under the market discount rules (secs. 1276-1278), gain on the disposition of a debt obligation that was issued after July 18, 1984, generally is treated as interest income to the extent of accrued market discount. Market discount is defined as the excess of the stated redemption price of an obligation over its basis immediately after acquisition, (provided that such excess is not less than a certain *de minimis* amount). In the case of a bond that has original issue discount, for purposes of the market discount rules, its stated redemption price is treated as the sum of its issue price and the amount of original issue discount that would have been includible in the income of an original holder.

Accrued market discount on an obligation generally is the amount that bears the same ratio to the market discount on such obligation as the number of days the taxpayer holds the obligation bears to the number of days after the taxpayer acquired the obligation until its maturity (sec. 1276(b)(1)). However, the holder may elect to accrue the market discount on an obligation using a constant interest rate.[43] A holder also may elect to include accrued market discount in income annually (sec. 1278(b)). Under present law, the method of allocating market discount among principal payments on an obligation where such principal is paid in multiple installments is uncertain.

If indebtedness is incurred to purchase or carry obligations that have market discount, interest on such indebtedness in excess of the amount of interest includible in income with respect to such obligations is deductible only to the extent that such interest exceeds the market discount allocable to the taxable year (sec. 1277). Any interest expense disallowed under this provision is allowable as a deduction in the year that the obligation is disposed of. This limitation on interest deductions is not imposed if the holder elects to include market discount in income currently.

The coupon stripping rules

The separation of ownership of the right to receive any payment of principal or interest on a debt obligation generally results in the application of the "coupon stripping" rules (sec. 1286). Under these rules, the holder of a debt obligation who disposes of the right to receive certain payments on the obligation, (other than a pro rata share of all payments), must allocate, (on the basis of fair market value), his basis in the obligation between the portion of the debt obligation that is disposed of and the portion retained, for purposes of recognizing gain or loss.

Following such a disposition, for purposes of the treatment of the holder, the retained portion is treated as a debt obligation having original issue discount equal to the excess of the amount that will be received upon payment of amounts due at maturity of such re-

[43] The constant interest rate method results in smaller amounts being treated as accrued market discount in the earlier years.

tained portion over the amount of basis allocated thereto. Similarly, a purchaser of the disposed of portion of the debt obligation is treated as having purchased a debt obligation having original issue discount equal to the excess of the amount payable upon maturity of such portion over the amount paid therefor. The original issue discount rules then govern the amount that the respective holders must include in income annually.

Withholding on interest paid to foreign taxpayers

In general, a 30-percent withholding tax is imposed on portfolio interest paid to foreign taxpayers (secs. 871, 881, 1441, and 1442).[44] However, the withholding tax is not imposed on interest paid on certain obligations issued after July 18, 1984 (secs. 871(h) and 882(c)). Although obligations issued by individuals generally are not eligible for the exception,[45] most mortgage-backed securities issued after July, 18, 1985, are eligible for the exception.[46] This is true even if the mortgage-backed security is in the form of a participation certificate in a grantor trust, in which case, the holder is for all other purposes treated as holding a proportionate share of the underlying mortgages. In such a case, however, the withholding tax is applied to the extent that the underlying mortgages were issued on or before July 18, 1984.[47]

Background

Participation certificates

Mortgage-related securities frequently are issued in the form of "participation certificates" in a pool of mortgages or other debt obligations held by a grantor trust. Holders of participation certificates are treated as the owners of proportionate shares of the trust's assets, and are required to include in income proportionate shares of the trust's income. Holders also are entitled to deduct proportionate shares of the trust's expenses.[48]

The use of grantor trusts has certain limitations, however. First, the trustees are not permitted to actively manage the trust's assets and have only the most circumscribed reinvestment power.[49] Second, the Treasury Regulations effectively prevent the issuance of more than one class of beneficial interest in the trust because those regulations would require the imposition of a corporate tax on the trust's income.

Because grantor trusts may have only one class of beneficiaries, all holders of participation certificates are subject to the risk of prepayment of all or a portion of their investment, depending on the extent of prepayments of the obligations held by the trust. This inability to cater to the differing investment objectives of various

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[44] A lower rate of tax may be imposed pursuant to a treaty.

[45] Temp. Treas. Reg. sec. 35a.9999-5(a) (Q & A 1).

[46] Temp. Treas. Reg. sec. 35a.9999-5(d) (Q & A 20).

[47] *Id.*

[48] *See* Rev. Rul. 84-10, 1984-1 C.B. 155; Rev. Rul. 77-349, 1977-2 C.B. 20; Rev. Rul. 71-399, 1971-2 C.B. 433, *amplified by* Rev. Rul. 81-203, 1981-2 C.B. 137, Rev. Rul. 80-96, 1980-1 C.B. 317, Rev. Rul. 74-300, 1974-2 C.B. 169, Rev. Rul. 74-221, 1974-1 C.B. 365, and Rev. Rul. 72-376, 1972-2 C.B. 647; Rev. Rul. 70-544, 1970-2 C.B. 6 and Rev. Rul. 70-545, 1970-2 C.B. 7, *both modified by* Rev. Rul. 74-169, 1974-1 C.B. 147.

[49] *See* Rev. Rul 75-192, 1975-1 C.B. 384.

investors has been a source of market dissatisfaction with these instruments.

Collateralized mortgage obligations

In addition to participation certificates in grantor trusts, many mortgage related securities are issued in the form of debt obligations of highly leveraged corporations that hold a portfolio of debt obligations, most frequently real property mortgages. These corporate debt obligations frequently are issued in differing maturities. The cash flow of the underlying mortgages is used to service the debt obligations, and the income of the corporation arising from the mortgages that it holds may be largely or completely offset by interest on the corporation's debt. To the extent such offsetting occurs, the income from the underlying mortgages is effectively taxed only to the debtholders. Arrangements of this sort are commonly known as "collateralized mortgage obligations" or "CMOs."

Although the ability to issue obligations of differing maturities is an advantage for this form of mortgage backed security, there also are several disadvantages. First, a corporate debt obligation and the income from such debt obligation are not among the types of qualifying assets or income for purposes of whether an entity qualifies as a REIT, even if the obligation is secured by real property mortgages.[50] In addition, such obligations do not qualify as "loans secured by an interest in real property" for purposes of a savings and loan association's ability to compute its bad debt deductions under the percentage of taxable income method.[51]

Second, where a corporation is formed for the sole purpose of holding debt obligations and issuing CMOs, in order to minimize the risk that the obligations would be treated as equity (the distributions with respect to which are not deductible unless, for example, the corporation qualifies as a REIT), rather than as debt, the corporation must have some, at least some, minimal amount of capitalization. This capital, which presumably must be supplied by the transferor of the mortgages, in effect increases the cost of issuing CMOs by subjecting such additional capital to a corporate layer of tax.

Third, in order for the corporate issuer to be treated as the owner of the underlying debt obligations, rather than as a mere trustee for the debtholders, the corporation generally must have some reinvestment risk with respect to the underlying obligations, i.e., the debt service may not be too closely matched to the cash flow generated by the collateral. Thus, the corporate issuer may not completely transfer all reinvestment risk to the CMO holders.

Fourth, the corporate issuer must pay income tax on the difference between the interest income on the issuer's assets and the interest on the CMOs.[52]

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[50] *See* sec. 856(c).

[51] *See* secs. 593 and 7701(a)(19).

[52] Such difference may arise, for example, where the CMOs are issued with different yields and different maturities, essentially because deductions with respect to higher yield, longer maturity debt tend to be weighted toward the later years relative to lower yield, shorter maturity debt.

Other formats for issuing mortgage-related securities

Other vehicles for investing in mortgages also suffer from certain disadvantages. While it is possible to use an S corporation to issue debt, under present law, only individuals can hold shares of an S corporation, and the maximum number of shareholders is limited to 35. REITs must have at least 100 shareholders. The ability of institutional investors to hold interests in limited partnerships may be limited under state law. Fixed investment trusts may be unattractive with respect to ownership by REITs and savings and loan associations because an interest in the trust may not be treated as a qualifying interest in real property or real property loans.

Issues

The stated purpose of the bill is to provide an indirect investment vehicle that does not contain the various disadvantages discussed above. However, the bill raises a number of issues:

First, is it appropriate to create another type of conduit entity under the tax laws for investment on mortgages? Moreover, should conduit treatment be provided for an entity that can issue several classes of securities?

Second, should only real estate mortgages qualify for any special treatment, or should any other debt obligations qualify as well?

Third, how should the OID and market discount rules be applied to divided interests in debt obligations? Should any newly created conduit treatment apply with respect to interests created in all outstanding obligations or only newly issued obligations?

Fourth, under what circumstances should foreign investors be eligible for the exemption from withholding tax?

Fifth, should any or all of the interests in a newly created conduit entity be treated as real estate assets for purpose of REIT qualification, or as real property loans for the purpose of qualification for percentage bad debt deductions of thrift institutions?

Explanation of the Bill

Overview

The bill would create a new form of mulitple class mortgage related security, known as a "collateralized mortgage security" (or "CMS"). Holders of the CMS would be treated as beneficial owners of the underlying mortgages. The bill would provide rules prescribing the income tax treatment of taxpayers who exchange mortgages for CMSs, the treatment of taxpayers holding CMSs, and the treatment of the disposition of CMSs. Among these rules are clarifications of the application of the OID rules to obligations the timing of whose maturities is contingent upon the timing of payments on the underlying collateral. In addition, certain new information reporting requirements would be imposed on issuers of CMSs.

Issuance of a CMS

Under the bill, a CMS may be issued in the form of an ownership interest in a corporation, association, trust, or partnership holding "qualified obligations," or as a debt obligation issued by any of the

above. Regardless of the form, the issuance of a CMS generally would be treated as a sale of the collateral securing the CMS to the holders of the CMS. Thus, the initial transferor of the qualified obligations and the the entity that holds such obligations and issues that CMSs would be treated as entirely separate entities, i.e., CMSs issued in the form of debt would not be treated as debt of the transferor of the qualified obligations and, except to the extent that the transferor holds CMSs, the income generated by the underlying collateral would not treated as income of the transferor.

A CMS could represent either a "regular" or "residual" interest in the underlying collateral. A regular interest would entitle the holder to receive specified principal payments (or analagous amounts in the case of CMSs not issued in the form of debt), the timing of which principal payments would be contingent upon the timing of receipt of principal payments on the underlying collateral and the amount of income from temporary reinvestments of portfolio cash flows. A residual interest would entitle the holder to receive amounts that are contingent with respect to both timing and amount upon the extent of prepayments on qualified obligations, the amount of income from temporary reinvestment of portfolio cash flows, and the amount of contingent payments received on qualified obligations. A regular interest, unlike a residual interest, could provide for the payment of interest on the outstanding principal balance of the CMS.

Eligible collateral for a CMS

In general, in order to qualify as a CMS under the bill, a security must be collateralized either by "qualified obligations" or "permitted investments." Qualified investments would include real property mortgage loans, interests in other CMSs, participation certificates representing beneficial interests in such obligations, guaranteed investment contracts, and property acquired pursuant to the default of or the substitution for a defective qualified obligation. Permitted investments generally would include cash and cash items that either were part of the initial collateral of the CMS or were subsequently acquired under certain circumstances, and the temporary reinvestment of cash flows.

Transfers of qualified obligations

In general, the transfer of qualified obligations to a CMS issuer (i.e., the entity that holds the collateral) in exchange for cash or other property would result in recognition of gain or loss to the transferor. If qualified obligations were transfered in exchange for regular interests, no loss would be recognized, but gain generally would be recognized, except to the extent provided in regulations. If qualified obligations are exchanged for residual interests, no gain or loss would be recognized.

If qualified obligations are transfered to a CMS issuer in exchange for regular and residual interests, or either or both such interests along with cash, the basis of the qualified obligations transferred would be allocated in proportion to the fair market value of the interests (and cash, if any) received. The transferor would be permitted to elect to treat the fair market value of residual interests as zero in certain circumstances.

Treatment of holders of CMSs

Under the bill, holders of regular interests generally would be taxed as if their regular interest were a debt obligation to which the rules of taxation generally applicable to debt obligations apply. The bill, however, would provide rules clarifying the application of the OID rules to debt instruments that, as may be the case with CMSs, have a maturity that is initially fixed, but that is accelerated based on prepayments on the underlying collateral. In general, the clarified OID rules would require OID for an accrual period to be calculated and included in the holder's income based on the increase in the present value of the obligation, taking into account the amount of acceleration of the obligation's maturity attributable to prepayments during the period as well as payments received on the CMS during the period.

Holders of residual interests generally would include amounts in income when paid or credited. The holder's basis, if any, would be recovered as a deduction on a straight line basis over the estimated duration of the residual. Any gain that was not recognized by the transferor of a qualified obligation on the transfer of such obligation to the issuer in exchange for a residual interest would be taken into income on a straight line basis over the estimated duration of the residual. Regulatory authority would be granted to the Treasury Department to issue regulations that would treat residual interests more like debt obligations in certain limited circumstances.

The bill also would provide for the acceleration of the recognition of income to holders in certain circumstances. Where the cumulative amount of income recognized by all holders of regular and residual interests (under the normal rules for the recognition of interest income, the OID rules as prescribed by the bill, and the special rules for residual interests) is less than the cumulative amount of income that would have been recognized if the CMS collateral were held by a single taxable entity, then the shortfall would be allocated to the holders of regular and residual interests in accordance with a formula prescribed by the bill. Any additional income so allocated would reduce the amount of income that must be recognized in later years.

Outside premium and discount

"Outside premium" on a CMS generally would be the excess of the holder's cost (or such other amount that ordinarily would be the holder's basis immediately after the acquisition) for a CMS over the adjusted issue price of the CMS. Outside premium also could arise where loss is not recognized on the transfer of obligations to the holding entity; the outside premium would equal the unrecognized loss.

"Outside discount" on a CMS generally would be the excess of the adjusted issue price of the CMS over the holder's cost for the CMS (or such other amount that ordinarily would be the holder's basis immediately after the acquisition). Like outside premium, outside discount also could arise in a case where gain is not recognized on the transfer of obligations to the holding entity.

Outside premium on a regular interest, to the extent it does not exceed the amount of OID with respect to such interest, would be amortized over the duration of the interest in the same proportion that the amount of OID includible for each accrual period bears to the total amount of OID. Any outside premium in excess of the amount of OID would be recovered ratably in the same proportion that the amount of principal (or similar amounts) received that year bears to the total amount of principal.

Outside discount on a regular interest would be treated as market discount. Under the bill, such discount would be recovered in the proportion that the amount of principal (or similar amounts) received bears to the total amount of principal. Such inclusions could be treated as capital gains to the extent that the underlying obligations would not be subject to the market discount rules, i.e., to the extent that such obligations were issued before July 19, 1984. If, however, at least 85 percent of the the underlying obligations were subject to the market discount rules, or at least 85 percent were not, then all of the obligations would be so treated.

Outside premium or discount on residual interests would be recovered ratably over the estimated duration of the residual.

Disposition of a CMS

In general, the disposition of a CMS would be treated like the disposition of a debt obligation. The market discount rules would be applied to determine the character of any gain recognized in the same manner as in determining the character of any recovery of outside discount upon payments of principal.

Other provisions

The bill would provide special rules relating to the accounting for expenses of issuance of CMSs, as well as ongoing expenses of the CMS issuer. In addition, the bill would impose a 100 percent tax on income from prohibited transactions, including gains from the sale or exchange of qualified obligations (with certain exceptions), and income relating to assets that are not permissible CMS collateral. The bill also would provide special rules for the sale of all of the assets of a CMS issuer and the distribution of the proceeds to the CMS holders.

The bill also would expand the interest and OID reporting requirements of present law and would apply such expanded provisions to CMSs as well as any other forms of mortgage related securities or debt obligations. Under the bill, reporting would be required with respect to interests held by corporations, registered securities or commodities dealers, RICs, REITs, and certain common trust funds. The reporting requirement also would include certain additional information relating to the taxation of any multiple class interests. CMSs would file annual information returns and would be subject to entity level audit procedures similar to those applicable to partnerships.

Effective date

In general, the provisions of the bill would be effective after the date of enactment.

Senate Finance Committee Bill

H.R. 3838, the Tax Reform Act of 1986, as reported by the Senate Finance Committee on May 29, 1986, (the "SFC bill"), contains certain provisions relating to the taxation of multiple class arrangements for investmenting in real property mortgages. In general, sections 1441–1445 of the SFC bill would allow multiple class investment in real property mortgages to be made in the form of partnerships, trusts, or corporations, and would not impose an entity level tax on the income from the mortgages, except to the extent that income from the mortgages otherwise would not be recognized currently to investors. The SFC bill would require the imposition of an entity level tax on vehicles for multiple class investments in real property mortgages that do not meet the requirements of the SFC bill, however. In addition, the SFC bill would clarify the application to mortgage-backed securities of the rules relating to the taxation of debt instruments.

Effective date.—The SFC bill would be generally effective with respect to taxable years beginning after December 31, 1986.

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